DIRECT ACTION IN MARINE REINSURANCE

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ABSTRACT

Marine reinsurance is an indemnity relationship in which the marine reinsurer indemnifies the insurance company for losses paid. When a parimary insurance company becomes insolvent, there may be insufficient funds in the estate to pay claims in full and it may take several years to distribute such funds.

For this reason, some insureds and third-party claimants seek to collect reinsurance proceeds directly from reinsurers (direct actions). However, The indemnity nature of the reinsurance agreement prohibits direct actions against reinsurers for reinsurance proceeds by insureds and other claimants. Under a marine reinsurance contract, the reinsurer does not assume the liability of the reinsured insurance company. In other words, the original insured cannot enforce his insurer's contract of reinsurance and is not a third-party beneficiary to that contract. Therefore, no privity exists between the reinsurer and the insured or persons claiming through him under the contract of reinsurance.

Absent an intent to benefit directly or create rights in insureds or other third parties, reinsurance proceeds are payable only to the reinsured insurance company or its domiciliary liquidator where the insurer becomes insolvent.

The insolvency of the reinsured does not affect this fundamental premise. Yet, in the face of this well-established principle of law, the original insured and other claimants still seek to recover themselves by making direct claims on the insolvent's reinsurers. The persistence in pursuing the variety of theories upon which the claimants have proceeded suggests a continuing unwillingness to accept the balancing of interests stay in liquidation statutes and the need for reinsurers to clearly settle their rights and obligations in reinsurance contracts.

LE RÉSUMÉ

La réassurance marine est un rapport de l'indemnité dans que le réassureur marin indemnise la compagnie d'assurances pour les pertes payé. Quand une compagnie d'assurances du parimary devient en faillite, il peut y avoir des fonds insuffisants dans la propriété pour payer des demandes dans plein et il peut prendre plusieurs années pour distribuer tel consolide.

Pour cette raison, quelques assurés et revendicateurs tiers cherchent à rassembler la réassurance continue de réassureurs directement (actions directes). Cependant, La nature de l'indemnité de l'accord de la réassurance interdit des actions directes contre réassureurs pour les produits de la réassurance par les assurés et les autres revendicateurs. Sous un contrat de la réassurance marin, le réassureur ne suppose pas la responsabilité de la compagnie d'assurances se réassurée. En d'autres termes, l'assuré original ne peut pas mettre en vigueur le contrat de son assureur de réassurance et n'être pas bénéficiaire tiers à ce contrat. Par conséquent, aucun privity n'existe entre le réassureur et l'assuré ou personnes qui réclament à travers lui sous le contrat de réassurance.

Absent une intention bénéficier directement ou créer des droits dans les assurés ou les autres troisièmes partis, les produits de la réassurance sont payables à la compagnie d'assurances se réassurée ou son liquidateur domiciliaire où l'assureur devient en faillite seulement.

L'insolvabilité des réassurés n'affecte pas cette prémisse fondamentale. Toujours, face à ce principe bien établi de loi, l'assuré original et autres revendicateurs encore cherchez à les retrouver en faisant des demandes directes sur les réassureurs en faillite. La persistance dans poursuivre la variété de théories sur que les revendicateurs ont continué suggère une involonté continue pour accepter le balancement de séjour des intérêts dans statuts de la liquidation et le besoin pour les réassureurs pour disposer leurs droits et obligations dans les contrats de la réassurance clairement.

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INTRODUCTION

A marine reinsurance agreement is one by which the marine reinsurer indemnifies the insurance company for losses paid. When a parimary insurance company becomes insolvent, the liquidator of the insolvent will take control and the guaranty fund will review the claim files and pay the claims. Unfortunately, the latter is often insufficient to pay all claims in full. Some insureds and third party claimants thus seek to collect reinsurance proceeds directly from reinsurers. These actions attempt to collect on claims otherwise reduced to available assets of the insolvent. Yet in most jurisdictions, such actions are not allowed because they contradict the indemnity nature of the reinsurance contract.

Reinsurance is a contract of indemnity where persons not party to the agreement have no interest and are not privy. Its indemnity nature prohibits direct actions against reinsurers by insureds, claimants, guaranty funds and ancillary receivers.

The common law theory of privity is another obstacle preventing the insured and other claimants from acting directly against the reinsurer. Firstly, they have no such common law or statutory right unless the reinsurance agreements so provide. Secondly, a party must establish reliance by the third party on either the presence of the reinsurers or on the reinsurer's role in the insurance coverage in order to establish privity since the original insured usually has no knowledge of the reinsurance coverage and cannot claim that he relied on it.[1]

Furthermore, the indemnity nature of reinsurance creates no privity between the reinsurer and the claimants. "*Reinsurance is a mere contract of indemnity in which an insurer reinsures risks in another company. The ordinary contract of reinsurance operates solely between the insurer and reinsurer and creates no privity whatever between the reinsurer and the person originally insured.*" [2]

On the other hand, there are significant exceptions to the general rule of law regarding the applicability of direct actions. For instance, in Venetsanos v. Zucker, Facher & Zucker[3], the court allowed a direct

action against the reinsurer because the reinsurer retained "some degree of control" over the claim settlement decisions.[4] However, this theory is of little help to the claimants who attempt to rely on it because the court did not set forth a clear line as to what would allow a third-party action against a reinsurer.

The cut-through clause is an example of contractual exceptions to the indemnity nature of reinsurance. In *Home Insurance Company v. Uniroyal, Inc.,* [5] the trial court noted that cut-through clauses may exist in these reinsurance contracts; therefore, if the insurance company were to become insolvent, the court would then be able to inspect the reinsurance contracts to determine whether cut-through clauses would allow the policyholder to make a claim directly against the insolvent insurance company's reinsurers.[6]

The thesis started with a brief introduction to the basic concepts of the contract of reinsurance. Chapter 2 analyzes the relationship between the reinsurer and the reinsured. Chapter 3 compares the contradictory viewpoints regarding the applicability of direct actions against reinsurers. Chapter 4 and 5 discusses the questions of "who may sue", "whom to sue" and "how to sue". Chapter 7 specifically deals with P & I clubs due to their particular importance to marine reinsurance while Chapter 8, for the similar reason, considers the effect of limitation of liability upon direct actions against the marine reinsurer. Summaries of various jurisdictions and applicable laws are given in chapter 6 and 9.

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1. Housing Auth. v. Envirohousing, Inc., *supra,* note 1, 441 F. Supp. at 1196 (1971)
2. 257 Ill. at 358 *citing* Barnes v. Heckla Fire Ins. Co., 56 Minn. 38 (45 Am. St. Rep. 438, 1982).
3. 638 A.2d 1333 (N.J. Super. Ct. App. Div. 1994).
4. Id
5. No. CV 93 522740S (Conn. Sup. Ct. 1995), reported in 5 Mealey's Reinsurance Rep. 21, at 7, Mar. 8, 1995.
6. Id.

CHAPTER 1: THE CONTRACT OF REINSURANCE

I. The Nature of Reinsurance Contract

1. The distinction between liability and indemnity insurance

The general distinction between the two types of insurance is that the coverage under a liability policy attaches when the liability attaches, regardless of actual loss at that time; but if the policy is one of indemnity, "*an action against the insurer does not lie until an actual loss in the discharge of the liability is sustained by the insured.*"[1]

Under a true indemnity policy, the insurer is only required to reimburse the insured for judgements that have already been paid as a result of the practice of pay-to-be-paid; and the shipowners are required to pay claims or judgements in full before they can be reimbursed.[2]

Liability policies, on the other hand, involve an agreement between an insurer and the insured whereby the insurer becomes jointly liable for any judgements against the insured.[3]

2. Reinsurance is a contract of indemnity

Reinsurance is a contract "*whereby a reinsurer contracts with an insurer to indemnify the insurer against loss or liability by reason of a risk which the latter has assumed under a separate and distinct contract as the insurer of a third person.*" [4]

Reinsurance proceeds are generally paid only to the insurer (the reinsured) and only after the reinsured company has paid a loss on the underlying policy. Having no direct contact with the reinsurance contract, the original insured usually is not entitled to recover from the reinsurer. Accordingly, the court had rarely upheld direct actions against the reinsurer by the insured.

The leading American case establishing reinsurance as a contract of indemnity is *Fidelity & Deposite Co. v. Pink* [5] where a primary company was insolvent and the reinsurer contended that the contract was one of

indemnity which required that the reinsurer reimburse the liquidator only for the appropriate proportion of the losses actually paid by the liquidator to claimants. The liquidator contended that he should be reimbursed the appropriate proportion of the primary company's liability to claimants regardless of the amount the insolvent company was able to pay the claimants. Based on the language of the reinsurance agreement, the Supreme Court found for the reinsurer.

In Canada, reinsurance was defined in *Canadian International Marine Underwriters Limited v. Symons General Insurance* as "*a contract or policy of insurance between the direct insurer and a reinsurance company, wherein the latter agrees to indemnify the direct insurer with respect to some portion of the risk assumed under the direct policy of insurance. The reinsurer does not appear as a party to the policy of direct insurance and there are no rights or obligations between the insured and the reinsurer*".[6]

The definition has not only clarified the indemnity nature of reinsurance but, essentially, set the basic tone of Canadian courts in handling direct actions by original insureds against reinsurers.

England made the first step towards the recognition of direct action in its *Third Parties Rights Act 1930* although the Act did not intend to include reinsurance. However, the Contracts (Rights of Third Parties) Act 1999[7] has eventually recognized direct actions against reinsurers by allowing the use of cut-through clauses in reinsurance contracts.

3. The characteristics of Marine insurance

Marine insurance, like any other type of insurance, involves two parties: the assured and the insurer (or carrier). A marine insurance contract is valid only when the insured has an insurable interest in the subject matter at the time of loss. Nevertheless, the complex circumstances in sea voyages require very specific arrangements for the provision of marine insurance.

The marine policy may cover the risks of a single voyage, or may insure for a certain period of time. Cargo policies may be on a single lot or may be open to cover cargo as shipped by the insured. Hull insurance, or vessel insurance, may cover a ship or a whole fleet.

Traditionally, the marine insurance contract is one that requires the highest degree of good faith. Any misrepresentation of a fact which is material to the underwriter will void the policy. In addition, a policy can be void for breach of any of the warranties implied by law, i.e. seaworthiness of the insured vessel or of the vessel carrying insured goods.

Modern hull policies cover most forms of liability. A "collision and running down" provision is contained in the standard hull policy to cover liability incurred for damage to another vessel or structure, and sometimes even personal injuries incurred. The protection and indemnity policy covers against collision liability not covered by the "collision and running down" clause, as well as against all other liability exposure.

Under a marine policy a loss can be partial or total. Total losses can be actual or constructive. Actual total loss arises when a ship or its goods can no longer arrive at their destination *in specie* or where the goods are so damaged that there is no reasonable possibility that they can be transported to their destination without complete destruction or change. Under actually total loss, no formal abandonment needs be made. Constructive total loss, by contrast, requires the tender of abandonment.

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1. 43 Am. Jur. 2d Insurance [section] 712 (1982)
2. See *Alex L. Parks & Edward v. Cattell, Jr.*, The law of Tug, Tow, and Pilotage 767 n. 149 (3d ed. 1994)
3. See 7 Couch on Insurance [section] 103:5, at 103-19 (Lee R. Roth & Thomas F. Segalla eds., 3d ed. 1997)
4. 13.A Appleman, *Insurance Law and Practice*, 7693, at 523 (1976 ed.)
5. 302 U.S. 224 (1937)
6. 1988 A.C.W.S.J.121416
7. U.K.1999.c.31

II. TYPES OF REINSURANCE CONTRACT

I. **Facultative Reinsurance and Treaty** [1]

Considering the methods of placing reinsurance, we could divide reinsurance into three categories: facultative obligatory reinsurance, facultative reinsurance and treaty reinsurance.

1. Facultative reinsurance

Under facultative reinsurance, specific risks are usually offered individually to reinsurers. The latter may choose to take all the risks or only a portion of them. Facultative reinsurance is commonly placed with a number of reinsurers, each issuing its own certificate and assuming a part of the liability.

2. Facultative obligatory reinsurance

As the terms suggest, under facultative obligatory reinsurance, a reinsurer enters into an agreement with a direct insurer to accept all reinsurance offered to it. The reinsurer has no option but to accept all the risks once the insurer decides to offer them.

3. Treaty reinsurance

This form of reinsurance is an agreement whereby the insurer agrees to cede and the reinsurer agrees to accept a whole class of reinsurances to be issued by the insurer in the future. The reinsurer may not pick or choose risks; it must automatically accept all risks in the group written by the reinsured. Treaty reinsurance typically involves the participation of numerous reinsurers, each agreeing to assume a percentage of the total liability under a single treaty.

II. **Proportional Reinsurance and Excess of Loss Reinsurance**

Both facultative and treaty reinsurance can be written on either a proportional or an excess of loss basis.

1. Proportional reinsurance

Under this category of reinsurance, the reinsurer accepts an agreed portion or percentage of the risk and agrees to indemnify the insurer to

the extent agreed upon. The riensurer will, under the reinsurance policy, participate [2] in the handling of claims paid by the insurer in respect of the risks reinsured.

2. Excess of loss reinsurance

The purpose of excess of loss reinsurance is to protect the insurer from an excessive loss on any individual loss or claim. [3] The reinsurer indemnifies the insurer against any loss under the original insurance in excess of an agreed amount and up to a limit of the reinsurance coverage.

1. *Christiania Gen. V. Great Am. Ins. Co.*, 979 F.2d 268,271 (2d Cir.1992)
2. It's noteworthy that to "participate" does not mean to "control". This is a key factor in consideration of the applicability of direct action rights.
3. *South British Fire and Marine Insurance Co. of New Zealand v. Da Costa* (1906) 1 KB 456

III. PARTIES TO THE AGREEMENT

It is essential that a reinsurance agreement properly identify the true parties to the agreement. Reinsurance agreements will contain such information in the form of a preamble or in a separate clause. The clause will typically establish that the agreement is solely between the reinsurer and the riensured listed and that no third parties such as reinsured insurance company policyholders or claimants against those policyholders has any rights thereunder. The intent is to prevent, or at least to discourage, direct actions against reinsurers by original insureds and other claimants, which are a common phenomenon at times when reinsureds became insolvent. Generally, absent special contractual provisions or legislations to the contrary, courts have refused to allow policyholders and claimants direct recoveries against reinsurers. A good example of the contractual provisions that allow the policyholder to recover directly against the reinsurer is the "cut-through endorsement". Cut-through endorsements are viewed as the exception to the general rule that no direct recovery will lie and will typically not be implied in the terms of a reinsurance agreement.

However, one court interpreted the language of the reinsurance agreement providing that the treaty was "subject to" the terms and conditions of the underlying policy to mean that the reinsurer had agreed to be bound by the reinsured's promises to pay its original policyholders[1]. Another court held that a reinsurer might be sued by the original insured for both unfair or deceptive acts and negligence when the reinsurer had assumed the responsibility of handling claims under policies it had reinsured[2]. Thus, although policyholders are generally viewed as having no rights against its insurer's reinsurer, particular languages contained in reinsurance agreements and practices of reinsurers under certain circumstances might give rise to the insured's right of direct action.

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1. *North River Ins. Co. v. Philadelphia Reinsurance Corp.*, F. Supp, No.Civ.A.91-1323 (WGB)

2. *Independence Ins.Co.v.Republic Nat.Life Ins.Co.*,447 S.W.2d 462,467 (Tex. Civ. App.1969)

IV. POLICY PROVISIONS OF MARINE REINSURANCE CONTRACT

Marine reinsurance agreements vary in their language and terms of coverage depending on the specific situation and the need of each case. A reinsurance agreement may contain such clauses and provisions as "following the fortunes", "errors and omissions", "notice", "arbitration", "claims cooperation", "salvage and subrogation", "accumulation and allocation of expenses", "extra contractual obligations", "punitive damages", "insolvency issues", and/or "cut-through" clauses. Furthermore, the wording of these clauses in different agreements may also significantly vary. The following is a brief introduction to several frequently used clauses in reinsurance contracts.

1. The "Honourable Engagement" clause

Reinsurance contracts are often considered to be "honourable engagements" rather than legal obligations.[1] This is due to the particular importance of the principle of utmost good faith and fair dealing in marine insurance. A reinsurance award "should be made with a view to affecting the general purpose of the reinsurance rather than in accordance with a literal interpretation of the language." [2] Generally, this provision is contained in the Arbitration Clause of the reinsurance agreement.

2. Insolvency Clause

A. *Insolvency Clause*

Insolvency clauses ensure that in the event of insolvency of the reinsured insurance company, reinsurance proceeds will be preserved for the benefit of all insureds, claimants, and creditors of the insolvent insurer.[3]

In *Fidelity & Deposit Co. v. Pink* [4], the United States Supreme Court held that reinsurance is a contract of indemnity and, therefore, a proportional reinsurer is required to reimburse the liquidator of an insolvent insurer only for its share of losses actually paid by the liquidator rather than for the amount of the insolvent insurer's liability to claimants. Since this decision will apparently defeat one of

the major purposes of reinsurance, which is for the insurer to take credit for the reinsurance, some jurisdictions, New York for example, has indicated an insolvency clause be a standard provision in reinsurance agreements.

The effect of the insolvency clause is to preserve the assets of the insolvent company. In theory, the reinsurer pays the same amount it would have paid had the direct insurer remained solvent. The insolvency clause has thus been viewed as a contractual exception to the indemnity nature of the reinsurance.

By an insolvency clause, the liquidator steps into the shoes of the insolvent insurer and assumes the rights and obligations of the insolvent insurer pursuant to the reinsurance agreement.

B. *Exceptions to the Insolvency Clause*

Insolvency clauses are designed to preserve the reinsurance proceeds for the benefits of claimants, creditors, and other third parties, including the original insureds. A cut-through endorsement is *a contractual exception under the purpose of leaving the reinsurance proceeds merely payable to the original insureds instead of other creditors of the insolvent insurer. Such provisions were held, to a large extent, unfair for they create preference amongst the creditors of the insolvent insurer.*[5] Therefore, it is not surprising that many courts have refused to recognize their validity.

(1). The Cut-Through Endorsement

It was said in *O'Hare v. Pursell*[6] that "reinsurance contract may be drafted so as to create a liability on the part of the reinsurer … in favor of the original insured." A cut-through clause can thus provide for an insured to bring a direct action, which usually claims payment of reinsurance proceeds directly against the riensurer in the event of the insolvency of the insurer.[7] A cut-through clause usually reads as: "*in the event the ceding company fails to pay, within the time provided in the above identified policy, any loss thereunder for which the ceding company is legally liable, the reinsurer for value received agrees hereby*

that it will immediately become liable for 100 percent of said loss and will make thereof at once directly to the parties named in said policy, or otherwise as their respective interest may appear..."[8]

The reason for the mortgagee or insured to request an endorsement is apparent: they are not satisfied with the financial rating of the reinsured company. Generally, the cut-through endorsement redirects reinsurance proceeds payable to the liquidator to the insured or mortgagee; pursuant to the insolvency clause, in the event of the insolvency of the reinsured. It assists small and growing insurance companies in competing for business that otherwise would be unavailable.

However, in the *Warranty Ass'n v. Commonwealth Ins. Co.*[9], the U.S. Supreme Court ruled that a fair and orderly liquidation required that reinsurance proceeds be paid to the liquidator and characterized the Cut-Through Endorsements as improper preferences because it is unfair to other claimants who will receive a lesser portion of their claims when assets are distributed. Accordingly, the court has refused to recognize the cut-through endorsement and ordered that the reinsurance proceeds be paid to the liquidator.

(2). The Guarantee Endorsement[10]

A variation of the cut-through endorsement is the *guarantee endorsement* whereby the reinsurer, when the reinsured is insolvent, undertakes to pay some or all of the primary company's obligations. The guarantee endorsement or bond raises preference issues similar to those involved with the cut-through endorsement and thus the courts are also reluctant to recognize guarantee endorsements.

(3). Assumption Agreement

An assumption agreement is an innovation by which the reinsurer, with the consent of the insured and the liquidator, assumes all the obligations and liabilities of the insolvent insurer.

3. Reinsurance "as original"

A contractual provision in the policy of the *Uzielli v. Boston Marine Insurance Co.* (1884)[11] reads: "*Being a reinsurance, subject to the same*

clauses and conditions as the original policy or policies, and to pay as may be paid thereon." The interpretation of the clause illustrates the restriction on the reinsured's right to recover from the reinsurer. Mr. Justice Bigham in *Western Assurance of Toronto v. Poole* [12] described the clause "to pay as may be paid thereon" in the following way: "*the reinsurer, when called upon to perform his promise, is entitled to require the reinsured first to show that a loss of the kind reinsured has in fact happened; and, secondly, that the reassured has taken all proper and businesslike steps to have the amount of it fairly and carefully ascertained… so long as liability exists, the mere fact of some honest mistake having occurred in fixing the exact amount of it would afford no excuse for not paying.*"[13]

On the other hand, the interpretation of the clause sometimes leads to a misconception that the reinsured must have paid a claim to the insured in order to receive the recovery from the reinsurer. This is not necessarily so. Mr. Justice Stirling in *Re Eddystone Insurance Company Ltd., ex parte Western Insurance Company Ltd.*[14] concluded: "*the words to pay as may be paid thereon do not stand in strict grammatical connection with those which immediate precede; but the effect of them is to impose an obligation as to payment on the reinsurers …*".[15]

4. Punitive damages clause

Punitive damages are "*damages awarded separately and in addition to compensatory damages, usually on account of malicious or wanton misconduct, to serve as a punishment for the wrongdoer and possibly as a deterrent to others. Sometimes referred to as 'exemplary damages' when intended to 'make an example' of the wrongdoer.*"[16]

Among the reinsurer's obligations to the reinsured, whether or not punitive damages are recoverable under a reinsurance agreement is one of the most complicated problems.

By learning the nature of reinsurance, we know that "*in a reinsurance agreement, the reinsurer agrees, for a premium, to accept all or part of*

the contractual obligations which the reinsured has assumed under certain insurance policies. Unless there is special coverage for it, the contract does not cover any tort liabilities of the insurance company itself. It is a contract which only covers liabilities under other contracts, for example, insurance policies. Since the reinsurance contract covers the liabilities of the reinsured insurance company under policies which it writes, it follows that it covers punitive damages assessed against an insured as long as the reinsured company is liable for them in the first place." [17] Therefore, whether punitive damages against the insured are recoverable under reinsurance contracts becomes in fact a question of whether punitive damages are covered by the original insurance contracts. The typical liability insurance policy has, and continues to, provide coverage in terms of, "all sums that the insured shall become legally obligated to pay as damages" or words to this effect. Courts have held this wording to be inclusive of punitive or exemplary damages as well as compensatory damages.[18] The only condition is that those punitive damages were vicariously assessed, which has been satisfied in most cases.

In *Ottawa v. All-Star Ins. Corp.*[19], where a reinsurer specifically provided punitive damage cover to its reinsured, the court held that the endorsement agreeing to indemnify the reinsured for punitive damage liability did not constitute reinsurance; but, rather, was direct liability coverage which permitted an insured to maintain an action against the reinsurer under the state's direct action statute.

It is equally noteworthy that in *Peerless Insurance Co. v. Inland Mutual Insurance Co.*[20], the court ruled that the reinsurer had a liability for punitive damages as a result of its participation in the claims handling practice of the reinsured. However, rather than on the contractual undertaking, the decision was based on the premises that the reinsurer was a joint tortfeasor with the reinsured.

In conclusion, it is clear that reinsurance contracts cover contractual obligations only, not torts. A reinsurer is not liable to a reinsured who pays for punitive damages against an insured when the

insurance contract does not cover punitive damages.[21] Under certain circumstances, punitive damages are however recoverable based upon direct action statutes or the participation in claims handling of the reinsured, rather than upon reinsurance provision.

5. Follow the fortunes/settlements clause

To "follow the fortunes" or "to follow the settlements" means that the reinsurer will automatically follow in every respect the insurance fortunes and settlements of the direct insurer on every policy reinsured. By undertaking to do so, the reinsurer obtains the right to associate in the defense of any claim or lawsuit involving the reinsurance and the reinsured company is obligated to cooperate with the reinsurer. The right to associate does not impose a duty on the reinsurer and means no more than investigation and interposition. Application of such rights by the reinsurer beyond certain extent may leave it exposed to the direct action by the original insured or third party claimants.[22]

A follow the fortunes clause requires the reinsurer to pay reinsurance proceeds as may be paid by the reinsured. The purpose of this type of provision is to avoid litigation by a reinsurer in cases where the reinsured has in good faith paid a settlement which is "*reasonably encompassed within the bounds of the underlying policy.*"[23] A follow the fortunes clause will bind the reinsurer unless the reinsurer can show that a cedent's settlement was both unreasonable and the product of dishonesty or unbusinesslike conduct.[24] Otherwise, the reinsurer may not "second guess the cedent's good faith decision to pay any claim that is arguably subject to coverage." [25]

Historically, there has been an inherent tension between the follow the fortunes clauses and the limitations on the liability of reinsurers.[26] It is crucial to understand that the follow the fortunes clause does not create liability that is inconsistent with the actual provision defining the scope of the reinsurance. In other words, the follow the fortunes clause does not operate to create any greater obligations for coverage on reinsurer than what exist under the reinsurance agreement. Neither does the follow the settlements clause. [27]

Similar to a follow the fortunes clause, a follow the settlements clause binds the reinsurer to pay the settlement or compromise agreed by the cedent unless it can meet its burden of proving either that the settlement was dishonestly arrived at or, that the cedent has failed to take all the proper and business-like steps to have the amount of loss fairly and carefully ascertained.

As a result of conflicting interests, reinsurers will never give up any opportunity to question the cedents' decisions. It will thus be important for reinsureds to carefully analyze and document the settlements they make and the coverage analyses they adopt, not only for purposes of successfully defending their insurance policies, but to enhance their ability to collect their reinsurance proceeds as well. In the meanwhile, the reinsurers today should more actively seek to assert the rights to participate in the defense of underlying insurance claims. Nevertheless, one thing they have to always bear in mind is that the application of rights beyond certain extent will leave them exposed to the possibility of being against directly by the original insureds.

It is arguable as to whether the principle of follow the fortunes/settlements is inherent in all reinsurance contracts. A U.S. court has ruled that the follow the settlements clause is applicable to facultative certificates even if the clause is not explicitly contained within the certificate. English courts however have ruled that reinsurance contracts must expressly contain follow the settlement provisions for the principal to apply.

On the other hand, the principle of follow the fortunes/settlements does not provide the cedent with a mere privilege over the reinsurer. They are also liable for certain obligations under the provision. For instance, the cedents should give reinsurers prior notice of a settlement, which will allow reinsurers to ask questions and at least have a basic understanding of the settlement.

6. Extra Contractual Obligations Clause

Some reinsurance contracts contain an "extra contractual obligation" (ECO) clause or an "Excess of Policy Limits" (XPL) clause. However, these

provisions may not be reinsurance at all. An extra contractual obligation arises separately from the coverage of any insurance policy reinsured and results from tortious conduct of the insurer. Extra contractual obligations may include both compensatory and punitive damages. Excess of policy limits means the liabilities covered by the underlying policy but in excess of the amount so covered. In *Ott v. All-Star Ins. Co.*[28], the court held that the ECO clause is not reinsurance and, therefore, subject to the direct action statute, thereby permitting an action by the insured directly against the reinsurer. Nevertheless, many reinsurance contracts still include coverage for extra contractual obligations despite the fact that such coverage may constitute primary insurance company errors and omissions insurance rather than reinsurance.

An extra contractual obligation clause may be considered a separate insurance of ECO claims or XPL judgments as opposed to reinsurance whereas the real basis for shifting the direct insurer's exposure to the reinsurer often hides behind the follow the fortunes clause of the reinsurance contract. Thus, the latter must be carefully examined.

7. Commencement and Termination Clause

This clause specifies precisely when the reinsurance assumed under the contract begins and ends. This clause may specify whether the agreement will end with the reinsurer running off coverage on existing policies or "cutting off" all coverage at the precise moment when the reinsurance contract terminates. When a terminating reinsurer continues to be liable for a specified period of time after termination of the reinsurance agreement, it is said to be "running off" the risk. When the reinsurer's liability is completely extinguished upon cancellation or termination of the contract, its liabilities have been "cut off." Unfortunately, many treaties are silent as to this question and controversies have long existed with regard to continuing obligations of reinsurers, if any, once a reinsurance contract has been cancelled, terminated or lapsed.

Some treaties specify a termination date while others may continue indefinitely until and unless cancelled by the reinsurer or the reinsured in the manner specified in the treaty. These continuous treaties will

often provide that a party may cancel with appropriate advance written notice at the anniversary date of the reinsurance contract.

Reinsurance agreements may also contain special termination provisions which provide that, upon certain conditions such as insolvency, change of reinsured insurance company management or financial impairment, the reinsurance agreement is automatically terminated.

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1. *Security Mutual Cas.Co.v. Affiliated FM Ins.Co.*,471 F.2d 238,246(8th Cir.1972)
2. See *Home Insurance Co. v. Administration Asigurarlilor de Stat* (1983); *Overseas Union Insurance Ltd. v. AA Mutual Int'l Insurance Co. Ltd.* (1988)
3. *See Cal. Ins. Code* (1971)*§ 922.2.*
4. 302 U.S. 224 (1937)
5. *See Ky. rev. stat.* (1968) *§304.5-140*
6. 329 S.W.2d 614,620(Mo.1959)
7. *Mercantile & General Reinsurance Co. v. Colonial Assurance Co.*, 184 A.D.2d 177, 591 N.Y.S.2d 1015 (1st Dep't 1992)
8. See *Mo. Rev. Stat.* (1990) *§375.246*
9. See *No. R-80-334* (April 13, 1983 P.R.)
10. *See N.Y. Insurance Code* (1992) *§1114(c)*
11. See 493 F.2d 329, 332, 1884 AMC 2155 (1st Cir.1884)
12. See 890 F.supp.1247, 1253 (D.N.J.1995)
13. See id
14. See 555 F.2d 38,43 (2d Cir.1977)
15. See id
16. See *Windt, Insurance Claims and Disputes* (1982) *§6.17*
17. See id *§6.11*
18. See *Skyline Harvestore Sys. v. Centennial Ins. Co.*, 331 N.W.2d 106 (Iowa 1983); *Koehring v. American Mut. Liability Ins. Co.*, 564 F. Supp. 303 (E.D. Wis. 1983).
19. 99 Wis.2d 635, 299 N.W.2d 839 (1981)
20. 251 F.2d 696 (4th Cir. 1958)
21. See *American Ins. Co. v. N. Amer. Co. for Prop. & Cas. Ins.*, 697 F.2d 79 (2d Cir. 1982)
22. See *Commercial Union Ins. Co. v. Pittsburgh Corning Corp.*, 789 F.2d 214, 219 (3d Cir.1986)
23. See *Insurance Co. of North America v. United States Fire Ins. Co.*, 67 Misc.2d 7, 10 322 (sup.ct.1971)
24. See *American Marine Ins. Group v. Neptunia Ins. Co.*, 775 F.Supp.703, 708-09 (S.D.N.Y.1991)
25. See *Weir v. Federal Ins. Co.*, 811 F.2d 1387, 1395 (10th Cir. 1987)
26. See *American Insurance Co. v. North American Co. for Property & Casualty Insurance*, 697 F.2d 79 (2d Cir. 1982)
27. See *Bellefonte Reins. Co. v. Aetna Casualty Co.*, 903 F.2d 910 (2d Cir.1990)
28. 299 N.W.2d 839 (Wis.1981)

CHPTER 2: THE RELATIONSHIP BETWEEN REINSURER AND REINSURED (AN ANALYSIS IN THE CONTEXT OF DIRECT ACTION THEORY)

I. Utmost Good Faith and follow the fortunes

Contracts of reinsurance are ones of utmost good faith.[1] Utmost good faith in the reinsurance context means the mutual relationship between reinsurer and reinsured. In other words, both of them owe each other the duty of disclosing material information. However, this is not absolutely true in reinsurance practice. In fact, reinsurer will not be asked or assumed to be aware of any material information. To the contrary, the insured has the duty to disclose such information.[2] Due to the complex circumstances, marine reinsurance requires a higher standard of material information disclosure[3]. Once there was a determination that the cedent failed to disclose material facts, the reinsurance contract could be rescinded.

Many, but not all, reinsurance contracts contain a follow the fortunes provision. This provision requires the reinsurers shall follow the fortunes of their reinsureds with respect to loss. Like any contract provision, the follow the fortunes clause can be intentionally omitted from the contract wording. In *International Surplus Lines Insurance Co. v. Certain Underwriters & Underwriting Syndicates at Lloyd's of London* [4], the court had found that even in the absence of express contract language, the follow the fortunes doctrine applied to all reinsurance contracts. However, the court of appeals in *Michigan Township Participating Plan v. Federal Insurance Co.*[5] found that it was error for the trial court to have implied an obligation to follow the fortunes when there was no follow the fortunes provision in the reinsurance agreement.

The principles of follow the fortunes rest on the good faith relationship of the parties. However, recent development in case law has shown that due diligence, rather than good faith and mutual trust, is becoming the basis for the reinsurance relationship.

Follow the fortunes clauses bind reinsurers only when the ceding company settles a claim which is "*reasonably encompassed within the*

bounds of the underlying policy."[6] In other words, a reinsurer is not bound under a follow the fortunes clause by any settlement outside the underlying policy (extra contractual obligation and excess of policy limits).

It is noteworthy that the reinsurer follows only the reinsurance fortunes of the company rather than its business fortunes.

1. *See Security Mutual Cas. Co. v. Affiliated FM Ins.* 471 F.2d 238,246 (8th Cir.1972); *Compagnie de Reassurance d'ile de France v. New England Reinsurance Corp.* 57 F.3d 56 (1st Cir. 1995).
2. See *A/S Ivarans Rederei v. Puerto Rico Ports Authority*, supra, 617 F. 2d at 905 (1st Cir. 1980).
3. In marine reinsurance, the failure of material information disclosure, regardless whether it's with the cedent's intention, will automatically terminate the reinsurance agreement.
4. No. -92-c-1500 (La. App. 4th Cir.15 Sept. 1992)
5. 592 N.W.2d 760 (Mich. Ct. App. 1999)
6. *INA v. United Sates Fire Ins. Co.*, 322 N.Y.S.2d 520,523 (sup. Ct. 1971).

II. Obligations of the ceding insurer/liquidator to the reinsurer

A. Ceding insurer

A ceding insurer owes its reinsurer a duty of utmost good faith. Reinsurance agreements usually contain provisions which require the ceding company to provide information concerning claims which reach or are likely to reach the reinsured layer. Moreover, a reinsurer is usually entitled but not bound to defend a claim at the reinsurer's expense under the reinsurance agreement. There are strong economic and business reasons for such provisions. Reinsurers must be aware of claims in order to properly prepare their financial statements and to provide the support and assistance desired by many primary companies.

Once a loss exceeds a ceding company's retention, the remaining loss dollars at stake belong to the reinsurer. In this situation, the reinsurer is the party who gains or loses from the manner in which claims are handled. As a result, the quality of claim handling and reporting by the ceding company is a key portion of the reinsurance agreement from the reinsurer's standpoint.

In a normal reinsurance agreement, the obligations of the ceding company to the reinsurer generally include the following issues [1]:

1) *The general duty of utmost good faith and fair dealing;*
2) *Competent underwriting and claims handling;*
3) *Notice of claims involving reinsurance;*
4) *Specific claim information;*
5) *Cooperation, including the right of the reinsurer to become associated with the investigation and defense of claims;*
6) *Account audits by the reinsurer, including reasonable access to all books and records;*
7) *Counsel and concur arrangements and;*
8) *Subrogation and salvage.*

B. Liquidator of the ceding insurer

The liquidator is the statutory successor of an insolvent company and steps into the shoes of the insolvent ceding company with respect to the

reinsurance agreement. Therefore, the liquidator is required to comply with the claim reporting and handling conditions in the reinsurance agreement in order to receive the benefit of the reinsurance proceeds. The liquidator has the obligation to collect subrogation and salvage, correct any underwriting improprieties and bring appropriate actions against any individual whose improper behaviour contributed to the insolvency. These obligations result from *(i) the terms of the reinsurance agreement; (ii) good faith obligations which underlie all contracts; and (iii) the duty of the liquidator to marshall assets for the benefit of all creditors.*[2]

Assuming the liquidator has fulfilled his or her duties under the reinsurance agreement, the amount due from the reinsurer is the reinsurance applicable to the claims which have been approved in the liquidation proceeding.

Since an insolvent insurer may be able to pay only a portion of the true claim value, it is in the interest of the claimant to submit an inflated claim in cases where reinsurance is involved in the hope that reinsurance proceeds will be increased allowing payment of a percentage of the inflated claim which approximates the true claim value. *The liquidator has a responsibility to the liquidation court, the reinsurers and the other creditors to marshall assets and distribute them in proper and equitable fashion. This may require that the liquidator deny in whole or in part a variety of claims including judgments entered by default, which were uncontested or collusive.*[3]

1. See Barry R. Ostrager, *Overview and Current Issues involving Reinsurance*, chapter 15, PLI Order No. H4-5184 (January-February 1994)
2. See id.
3. See id.

III. Obligations of the reinsurer to the ceding insurer

Introduction

Based upon the indemnity nature of reinsurance contract, the reinsurer has no obligation until the reinsured has paid a claim.[1]

Once the claim has been paid, the reinsurer is obliged to indemnify the ceding insurer in accordance with the reinsurance contract.

Ordinary reinsurance merely indemnifies the primary insurer against loss rather than against liability. However, if a reinsurance contract provides, or the conduct of the reinsurer demonstrates that it takes charge of and manages defense of suits against the original insured, the reinsurer may be held privy to the insurance contract and is therefore exposed to direct action by the original insured.[2]

Similarly, if a reinsurer plays a major role in handling and defense of claims by insureds, it in fact acts as a primary insurer and therefore has to take the same obligations as an insurer to the insured.

Although a reinsurer has no obligation to become involved in claims, the reinsurer might be required to negotiate in good faith should it choose to be an active participant.[3] Should a reinsurer exercise its right to defend a claim against an insolvent carrier, it is prohibited from paying any settlement directly to the claimant without the approval of the liquidator since such a payment would undercut the statutory scheme of liquidation and take unfair advantage of a claimant's willingness to settle a claim against an insolvent company.[4] If unfortunately such a payment has been made directly to the claimant without the liquidator's approval, the reinsurer must pay the same claim a second time to the liquidator since reinsurance proceeds are for the benefit of all creditors.

A. Extent of reinsurer's liability

The liability of a reinsurr to its reinsured cannot be higher than the liability of the reinsured under its original policies.[5] In other words,

the outer limits of a reinsurer's liability are set by the liability of its reinsured. A reinsurance contract can, sometimes, narrow these outer limits.

B. Extra contractual obligation

The primary purpose of reinsurance is to allow the cedent to lay off to the reinsurer a portion of the losses covered by the cedent's policies. Sometimes, however, reinsurers can and do agree to cover losses outside the insurance policy issued by the cedent. Generally speaking, the reinsurer is not liable for liability imposed on the cedent in excess of its obligations under the primary policy, such as for bad faith, punitive damages, excess judgments and the like because these types of damages are outside of the policy obligations of the cedent, which is the only thing insured by the reinsurance contract.

In other words, extra contractual obligation is not an inherent part of the risk transferred in a reinsurance contract. The risk assumed by the reinsurer is determined by the reinsurance contract.

Since there is no privity of contract between the reinsurer and the original insured nor is there a sound basis for a subrogation theory, there should be no basis on which to shift to the reinsurer the extra contractual liability that is imposed on the reinsured in favor of the primary policyholder. Therefore, absent an express assumption in the reinsurance contract, extra contractual obligation will be remained with the cedent.[6]

Furthermore, even when there is a provision in the reinsurance agreement stating that the reinsurer is liable for certain extra contractual obligations, the courts may still decline its validity if the insurer engages in a bad faith refusal to settle case within its retention.[7]

However, the increasing involvement of reinsurer in the underlying claims handling results an exception to this general rule of non-liability. The leading case is the *Peerless Ins. Co. v. Inland Mut. Ins.*

Co.[8] where the reinsurer's activities gave rise to a joint enterprise in the claim's handling and, therefore, a mutual obligation with respect to extra contractual damages.

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1. See *China Union Lines v. American Marine Underwriters Inc.*, 755 F.2d 26, 30(2d Cir.1985)
2. See *Venetsanos v. Zuker, Facher & Zucker*, 638 A.2d 1333(sup.Ct.1994)
3. See *Cf. Duber Indus. Sec., Inc. v. Allendale Mut. Ins. Co.*, Civ. 69,133 (Sup. Ct. 232 595) (Cal. Ct. App. February 16, 1984).
4. See *Ainsworth v. Gen. Reins. Corp.*, 751 F.2d 962 (8th Cir. 1985).
5. See *Independence Ins. Co. v. Republic Nat. Life Ins. Co.*, 447 S.W.2d 462,467 (Tex. Civ.App.1969).
6. See *Pringle v. Standard life & Accident Ins. Co.*, 391 N.E.2d 677 (1n.Ct.App.1979)
7. See *Kaiser Found. Hosps. V. Safeway Stores, Inc.*, 610 P.2d 1038, 1042-43 (Cal.1980).
8. 251 F.2d 696 (4th Cir. 1958)

IV. Reinsurer's Right to Setoff in Liquidation of Ceding Insurer

Parties to a reinsurance contract are entitled the right to net accounts due between them often by statute. The right of parties to offset debits and credits was recognized in the English law in equity and in the bankruptcy law. This principal was carried forward into the American law in equity and bankruptcy and has been applied in the context of an insolvent insurance company. As a practical matter, most reinsurance agreements contain a setoff clause which permits either party to setoff debts and credits under the agreement. In particular, the reinsurer's right to setoff debts with insolvent insurer has been recognized by most courts. Furthermore, a number of courts have allowed reinsurers to assert setoffs against claims by the liquidator of an insolvent ceding company in a forum other than the liquidation proceeding. In *Commissioner of Insurance v. Munich American Reinsurance Co.*[1], the court held that a setoff is appropriate between mutual debtor-creditors, even if one of them is insolvent at the time that the right to the setoff is asserted. The court further noted that there was nothing explicit or implicit in the statutory scheme for the liquidation of insolvent insurers that makes common law principles of setoff inapplicable and that the regulatory provisions were simply silent on the question of setoff. The court concluded that there was nothing unique to the liquidation of an insolvent reinsurer that required a different rule, holding that "*the argument that the reinsurer would receive an improper preference through setoff, while reasonable . . . has been generally rejected in this country.*" [2]

It seems clear that where an insurance statute provides for the right of offset, and where the statute does not preclude the exercise of this right in the event of insolvency, the right remains. The cases make clear, moreover, that the right of offset applies despite the absence of a written agreement between the parties or the absence of a specific provision in the relevant state's liquidation law recognizing the right of offset.

In *Carr v. Hamilton* [3], the Supreme Court held that, even where no statutory authorization for offset existed, debts due to and from the same persons, in the same capacity, were subject to setoff even where one such legal person was an insurance company then subject to statutory liquidation. In *Carr* the Court allowed a claim under a mortgage deed to be offset against a claim arising under an endowment policy.[4]

In *Stamp v. Insurance C. of N. Am.*[5], the court however found an important issue to be considered when determining setoff rights. That is the notion of mutuality. The court stated that the mutuality between parties requires that pre-liquidation debts owed by the reinsured can only be set-off against pre-liquidation debts owed to the reinsured and the post-liquidation debts owed by the reinsured can only be set-off against the post-debts owed to the reinsured.

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1. 527 F. Supp. 444 (C.D. Cal. 1981)
2. ID
3. 129 U.S. 252 (1889)
4. See also *Downey v. Humphries*, 227 P.2d 484 (Cal. Dist. Ct. App. 1951)
5. 908 F.2d 1375 (7th Cir.1990)

Chapter 3: Can original insured or claimants against insured bring a direct action against reinsurer?

Introduction

An insolvent insurance company will no longer pay its claims until the liquidator takes control and the guaranty funds have reviewed the claim files. Since the funds are limited, part of the claims may be paid only partially or even not paid at all. Furthermore, the distribution of the funds may take years, which is absolutely not a pleasant result for the creditors. Therefore, it is understandable that some insureds and claimants who have obtained judgements against the insureds seek to collect reinsurance proceeds from reinsurers by taking a direct action.

However, the practice of direct actions is even more problematic. First, it brings uncertainty to the apportionment of the insurer's assets and the specific priority arrangement of distribution.[1] Secondly, the recognition of direct action against reinsurer will lead to a flood of suits. The litigation process might be even more time-consuming and expensive for the claimants than the distribution of funds in accordance with liquidation statutes. Thirdly, the practice of direct actions runs counter to the indemnity nature of the reinsurance contract. The original insured is not a party to or in privity to that contract of reinsurance.

Therefore, where the reinsurer did not have the right to control settlement negotiations nor did it participate in same, where there was no third-party beneficiary contract between the companies and the reinsuring contract did not create a principal-agent relationship, and where original insured was not privy to the reinsurance contract nor was he or she owed any duty by reinsurer as a result of it, reinsurer was not liable in garnishment action brought by injured party against insured. [2]

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1. *Motlow v. Southern Holding & Securities Corp.*, 95 F.2d 721 (8th Cir. 1938), cert. denied, 305 U.S. 609 (1938). See also *Consumer Supermarket* No. 2 v. Underwriters at Lloyds, 189 So. 2d 648 (Fl. Dist. Ct. App. 1966).
2. *British Columbia Hydro & Power v. Dunwoody Ltd.* (1986) 1 W.W.R. 476 (Man. C.A.), app. den., (S.C. Can. December 16, 1985).

I. Reasons to deny direct action against reinsurer

1. No direct action under common law - Privity Requirement:

At common law, the reinsurance agreement is one by which the reinsurer indemnifies the ceding company for the loss paid. The reinsurer is in no ways liable to the original insured because the original insured is not a party to the reinsurance contract and there is no privity between the insured and the reinsurer. The insured, not being a party to the contract of reinsurance, had no right to proceed directly against the reinsurers.

The traditional approach to overrule direct actions against reinsurers is to argue the lack of privity to the reinsurance contract.[1] "*There is … no privity between the original insured and the reinsurer; that latter is in no respect liable to the former, as a surety or otherwise, the contract of insurance and reinsurance being totally distinct and disconnected.*"[2] Usually, the insured has no knowledge of the reinsurance obtained by the insurer. The unawareness, however, does not constitute a sufficient excuse for the third parties to exercise the right of direct action.[3] Another U.S. court held that "*reinsurance involves no transaction or privity between the insurer and those originally insured. Such [reinsurance] contracts can only be construed as providing indemnity . . . for loss actually paid.*"[4]

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1. See *Taggert v. Kiem,* 103 F.2d 194 (3d Cir. 1939). See also *Gill v. Blackhawk Mut. Ins. Co.*, 152 N.E.2d 220 (Ill. App. Ct. 1959).
2. *Appeal of Goodrich,* 2 A. 209, 211 (1885)
3. *See Safeway Trails, Inc. v. Stuyvesant Ins. Co., 211 F. Supp. 227 (M.D.N.C. 1962), aff'd, 316 F.2d 234 (4th cir. 1963).*
4. *See Employers Reinsurance Corporation v. American Fidelity & Casualty Co.*, 196 F. Supp. 553, 561 (W.D. Mo. 1959).

2. Pay-to-be-paid rule and No-Action Clauses

It has often been seen that the pay-to-be-paid rule, which is the primary principle of indemnity insurance, is used as the defence of reinsurer against direct action by the insured. This is particularly so in P. & I. Clubs' insurance.[1]

Under indemnity policies, an injured party is theoretically unable to secure recovery from an (re)insurer if the insured failed to make payment, since no liability to reimburse the insured can arise until after a payment of a claim or judgement. Pay-to-be-paid clauses, therefore, insulate (re)insurers from potential claims of third parties. Direct action statutes are designed, at least in part, to abolish such clauses as a means for the (re)insurer to escape liability where the insured has become insolvent.[2]

As a contractual arrangement to prevent direct action from happening, no-action clause is a general practice in most reinsurance agreements. No-action clause is, unless prohibited by statute or public policy, valid and enforceable, and a policy containing such a clause is one of strict indemnity only, under which there is no right of action until the insured sustains a loss by the payment of the liability. The minority view is that even though the policy contains a "no-action" clause, if there are provisions for defense of actions by the reinsurer or giving to the reinsurer control of litigation against the insured, these latter provisions will prevail, and the policy will be declared a contract against liability rather than against loss.[3]

In case of the conflicts between the policy provisions, i.e. a no-action clause, and the statute, it is generally held that the latter prevails because it is a general rule that no contract will modify the law.

In U.S., Where policy provisions conflict with provisions of statutes, the latter prevails.[4] Sometimes the policy contains a "Pure Indemnity Insurance" Clause which functions pretty much the same as a no-action clause does. Such a clause is also superseded by direct action statutes where there is a conflict.[5]

The courts of U.K. held that no-action clauses, statements that no action shall be brought until certain conditions precedent have been satisfied, were prohibited, but clauses requiring judgement were not prohibited.[6]

1. See the chapter on P. & I. Insurance.
2. See 7 *Couch on Insurance* (1972)[section] 106:66, at 106-93 to-94.
3. See *Elliott v Belt Auto. Ass'n,* 87 Fla 545, 100 So 797 (Fla. 1924).
4. See *Goerss v Indemnity Co. of America,* 223 Mo App 316, 3 SW2d 272 (1928).
5. See Saunders v. Austin W. Fishing Corp., 224 N.E. 2d 215, 217-18 (Mass. 1967).
6. See Firma C-Trade SA v. Newcastle P. & I. Association (the *Fanti*), 2 app. Cas. 1, 29 (1991).

II. Reasons to uphold direct action against reinsurer

Introduction

Despite the fact that most courts and jurisdictions are reluctant to recognize the original insured's action against the reinsurer, the claimants have never stopped trying. Two things make them so determined: first, the reinsurers are their last chance to recover their damages in the event of insolvency of the insurers. In fact, the insureds rarely act against the reinsurers when the insurers are still solvent and able to pay. The mere object of acting against reinsurers and insurers jointly is to secure their sufficient recovery or, in some jurisdictions, to satisfy the procedural requirement. Secondly, some jurisdictions are, indeed, convinced by the claimants. Their decisions for the original insureds become enormously encouraging for the insureds.

There are several practical ways of bringing the reinsurers to court. A claimant may argue that the reinsurance has become liability insurance when the insurer is in liquidation; or he may argue the insolvent insurer was acting merely as an agent of the riensurer and therefore the latter should be liable to the insured, especially when they are out of business; also he may prove the reinsurer is liable by showing its actual control on the underlying insurance claims. Furthermore, the insured may look in the reinsurance contract for the provisions that allow such a direct action.

The result of a direct action against reinsurer depends very much on the court's attitude towards its direct action statute and provisions and, of course, the terms of the reinsurance contract.

1. Transformation of Indemnity into Liability--Louisiana's viewpoint

In some jurisdictions, it is considered a public policy that liability insurance policies are issued for the benefit of all persons injured through the negligence of that/those insured(s).

However, reinsurance is apparently invented merely for the benefits of insurers rather than that of the insureds or any other third party. If

this is admitted, there should be no argument on saying reinsurance is a contract of indemnity.

Here comes the most arguable hypothesis first proposed by the court of *Fontenot* [1]: reinsurance has been transformed from indemnity insurance to liability insurance once insolvency of the insurer involves. The direct action against the reinsurer by the original insured is, therefore, within the scope of the direct action statute.[2]

If this is true, direct action against reinsurer should be permitted in consistent with the public policy.

In the *Fontenot* case, the injured party in an automobile accident took an action against negligent motorist, motorist's employer, employer's liability insurer and reinsurer of insurer, virtually everybody. The court held that "*where liability insurer becomes insolvent, insurer's reinsurance agreement becomes contract of liability insurance within direct action statute and reinsurer is amendable to direct action by third party for an injury by original insured for which reinsured insurer is liable*". The court denied the privity requirement on the ground that "*stranger has right of direct action against the liability insurer under direct action statute*". [3]

2. Control over settlement—New Jersey's viewpoint

In *Venetsanos v. Zucker, Facher & Zucker* [4], the primary insurer was insolvent. However, the court found the reinsurer had performed the duties typical of a primary carrier such as underwriting the risk, claims adjusting, and conducting settlement negotiations. Therefore, the court allowed a direct action against the reinsurer because it retained some control over the claim settlement decisions. The court did not set forth a bright line as to what would allow a third-party action against a reinsurer. It merely stated that if the reinsurer had "*some degree of control over the decisions concerning settlement with the third-party claimant*,"[5] a direct action against that reinsurer may be allowed.

In *Peerless Ins. Co. v. Inland Mutual Ins. Co.*[6], pursuant to the "claims cooperation" provision, *Peerless* investigated the merits of the third-party claim and left the decision to settle the case with the

cedent, Inland Mutual. An excess judgment resulted and the court found that *Peerless and Inland Mutual* were engaged in a joint enterprise and held *Peerless* liable to *Inland Mutual* for its proportional share of the excess loss.

This decision raises serious concerns about the practice of fronting and the consequent liability of reinsurers engaging in this practice.

The phrase "some degree of control" is troublesome for two reasons. First, it is undefined. The court gave neither the measure of how much is "some degree" nor the description of acts of "control" over the insurance contract. Second, it imposes additional obligations on reinsurers who are not in any way performing acts typical of primary insurer.

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1. See 247 So.2d 572 (La.1971)
2. See id
3. In fact, the Louisiana's Direct Action Act applies to both indemnity and liability insurance, the theory of transformation aims more to clear the Pay-to-be-paid rule of indemnity insurance than to prove the appropriateness of applying the Act.
4. See 638 A.2d 1333 (N.J. Super. Ct. App. Div. 1994)
5. See id
6. 251 F.2d 696 (4th Cir. 1958)

3. Third-Party Beneficiary [1]

Insureds and claimants against insureds have contended that they should be able to recover directly from the reinsurer as third-party beneficiaries of the reinsurance agreements. Some courts have recognized direct actions against reinsurers by the original insureds/claimants on this ground. For example, under New York insurance statutes, injured third parties are allowed to bring a direct action against the tortfeasor's insurer to recover up to the policy coverage limit, but only when the injured parties have obtained a judgment against the insured tortfeasor. However, for a third party to benefit under a reinsurance contract, the contracting parties must have intended to benefit that third party, and their intent must appear from the terms of the contract.[2]

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1. See *Fontenot v. Marquette Casualty Ins. Co.*, 247 So. 2d 572 (La. 1971). See also *Arrow Trucking Co. v. Continental Ins. Co.* 465 So.2d 691 (La. 1985)
2. See *Ascherman v. General Reinsurance Corp.*, supra, 183 Cal.App.3d at 311. (Cal. App. 1983)

4. Agency theory

Another approach to avoid the liquidation estate of an insolvent insurer is to argue that the insurer acts merely as the agent of the reinsurer. Under this theory the reinsurer becomes liable to the claimant outside and independent of the liquidation proceedings although it was rarely recognized by the common law courts.

The theory neglects the indemnity nature of reinsurance contract and the privity principle of common law. Under traditional reinsurance arrangements the primary insurer remains fully and directly liable to the insured for the full coverage of the policy. Thus, the reinsurance contract is one of indemnity against loss, not one of liability directly to the insured, and not one of co-insurance whereby the reinsurer's obligation is to reimburse its reinsured in accordance with the reinsurance agreement.

Additionally, whether the reinsurance exits makes actually no difference in the amount of settlement of a claim. The primary company is fully free to commit itself to the claim amount, whether or not it had reinsurance. Although they may be consulted (consultation with or reporting to the reinsurer on major claims is not tantamount to control of the negotiations by the reinsurer), the reinsurers cannot preclude any settlement reached by the reinsured.

A principal/agent relationship between the reinsurer and the primary insurer or its employees cannot be established if privity between the reinsurer and the insured or other third parties claiming directly against the reinsurer cannot be established.

The courts of the United States and England have generally refused to recognize the agency theory.

In the case of *Aetna Insurance Co. v. Glens Falls Insurance Co.*[1], the court determined that: "*The appeal involves the existence vel non of an agency relationship between two reinsurers and an employee of the reinsured.*" The employee in that case was an underwriter. The court held that "*the district court's analysis of the transaction portrayed Palmer (the insurer's employee) as wearing two hats at the same time, i.e., as acting for the reinsured in ceding the reinsurance and at the same time*

acting for the reinsurers in accepting the reinsurance. This misconstrues the nature of the reinsured and the reinsurers. The reinsurance treaties, and not Palmer, bound the reinsurers." [2]

One U.S. district court has expressly found that, despite the representations by the primary company's agent regarding the reinsurance and the reliance upon those representations by the insured, the agents of the primary company "*were not agents of the reinsurers and had no authority to speak for them.*"[3]

Similarly, the courts in England also believe that, absent a finding of privity between the reinsurer and the insured, no agency relationship was created between the reinsurer as principal and the primary company as its agent.[4]

Under common law, two conditions must be satisfied in order to establish a principal-agent relationship. The first is the control by the reinsurer on the actions of the primary company, which cannot be discovered in normal reinsurance practice. The second requirement is the power of the agent to alter legal relationships between the principal and the third parties, i.e. the original insured. In reinsurance cases, the insurer will however never be able to do so because there is no relationship between the reinsurer and the insured at all according to the privity theory of common law, unless the reinsurance contract expressly provides otherwise.

Can we therefore conclude that the reinsurance relationship is in no ways possible to be a principal-agent one? The answer is NO. In the case of *Reid v. Ruffin* [5], the court found that the rights and obligations of the reinsurer contained in the reinsurance agreement were sufficient to create a principal-agent relationship as a matter of law. The court went on based upon this discovery: "the reinsurer's course of conduct of routinely allowing settlements above the retention without the reinsurer's approval bordered on a joint venture rather than a traditional reinsurance relationship." [6]

We can now conclude, based on our previous analysis, that although there is a presumption of non-existence of a principal-agent relationship between parties to a reinsurance contract, the facts of individual cases

and the terms of the contracts may give rise to such a relationship despite the presumption.

In examining the nature of a reinsurance relationship, there are two layers of tests must be done. The first step is to determine the privity of parties to the contract. If no privity between the reinsurers and any party other than the insurer existed as a matter of law, no agency relationship could exist between the employees of the primary company and the reinsurers. The second step is to look at the individual case and the terms of the contract. The reinsurance relationship is always an indemnity insurance relationship merely between the reinsured and the reinsurer until and unless the facts and the terms of the contract provide otherwise.

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1. *See* 453 F.2d 687 (5th Cir. 1972).
2. *See also Colonial Brick Corp. v. Federal Sur. Co.*, 72 F.2d 964 (4th Cir. 1934).
3. *See Safeway Trails, Inc. v. Stuyvesant Ins. Co.*, 211 F. Supp. 227, 233 (M.D.N.C. 1962), *aff'd,* 316 F.2d 234 (4th Cir. 1963). *See also* United States, to use of Colonial Brick Corp., *et al.* v. Federal Surety Co., *et al.*, *supra,* note 35.
4. *See English Insurance Co., Ltd. v. Official Receiver and Liquidator or National Benefit Assurance Co., Ltd.* 196 F. Supp. 553 (W.D. Mo.1959)
5. See *Slotkin v. Citizens Casualty,* 614 F.2d 391 (2d Cir. 1979). See also *A/S Ivarans Rederi v. Puerto Rico Port Auth.*, 617 F.2d 903 (1st Cir. 1980).
6. See Ibid.

5. Specific provision in reinsurance contract may bind the reinsurer

Despite the majority view of courts, it is possible for the reinsurance agreement to be so phrased that it allows a direct claim by the original insured. This is so where a proper third-party beneficiary contract to that effect may be found or where the reinsurer is a successor which has assumed the original insurer's liabilities. In applying this rule, reinsurance contracts have been found to allow the original insured to proceed directly against the reinsurer when the policy included a clause indicating that the reinsurer agreed to assume and carry out directly with the policyholder any of the policy obligations of the ceding insurer or a judgment in excess of policy limits clause providing for participation by the reinsurer in excess verdicts against the reinsured. However, the language of the contract does not constitute a sufficient reason for recognizing direct action, the facts of the reinsurance are also taken into the court's consideration.

At times, an original insured has been allowed to bring an action directly against the reinsurer not by virtue of the reinsurance contract terms, but by virtue of the original policy which assigned the right to sue the reinsurer directly by the insured.

These contract terms indicating the direct relationship between the reinsurer and the insured can often be seen in a so-called cut-through clause or endorsement.

A cut-through clause is an endorsement which is generally contingent upon the insurer's failure to pay or its insolvency and which requires the insurer's reinsurer to pay directly to the policyholder a stated portion of the loss. A cut-through is not technically a novation, substituting the reinsurer for the insurer on the original policy, nor is it an assumption certificate whereby the reinsurer assumes all policy obligations of the insurer and, thus, relieves it completely. Whether or not a cut-through clause is enforceable has often been one of the most arguable questions in courts.

In 1977 the largest insurer in Puerto Rico was declared insolvent. Subsequent events identified several reinsurers which had issued cut-through endorsements. Questions over the enforceability of these endorsements arose and resulted in litigation.[1] Arguments were made that traditional principles of reinsurance law were applicable and that the reinsurance due the insolvent was a general asset of the estate payable solely to the insurance commissioner. It was asserted that, for public policy reasons, the cut-through did not survive the insolvency of the insurer.

The Superior Court found, however, that the cut-throughs survived the insolvency and that the reinsurers were directly liable to policyholders holding valid endorsements. The court also relieved the guaranty fund of its obligation to pay where a valid cut-through was issued to the policyholder. The case is currently on appeal to the Puerto Rican Supreme Court, which has had the matter under advisement for nearly two years.

In the case of *the Mercantile & General Reinsurance v. Spanno*, the court stated that the language of policy is not sufficient to create third party beneficiary status in the insured. Furthermore, A proper cut-through clause would provide expressly that the assured would be paid by the reinsurer if necessary or could sue the reinsurer directly.[2]

1. *Warranty Ass'n of Ins. v. Commonwealth Ins. Co., et al.*, Superior Court of Puerto Rico, San Juan Part. Div. No. 79-6544(1003) (June 5, 1980)
2. *Greenman v. General Reinsurance Corp.*, 262 N.Y.S.569 (Sup. Ct. App.Div.1933)

Chapter 4: Who May Sue and Whom to Sue

I. Who may sue?

1. Direct Action by Insured/the Assignee of the insured

It has been said that the reinsurance contract is indemnity in nature and therefore does not render the reinsurer directly liable to the original insured. However, reinsurers are increasingly faced with claims that they should have pursued a settlement with the original insured or claimants against the original insured. Many such cases involve situations in which the original insurer has become insolvent. The insolvency of the original insurer has generally been held not to make the reinsurer directly liable to the original insured, although there is limited authority to the contrary.

It is clear that reinsurance is a contract merely between the ceding company and the reinsurer. The original insured has no interest in a reinsurance contract. Therefore, the reinsurance contract does not create privity between an insured and a reinsurer. The contract of insurance and the contract of reinsurance are separate, distinct, and totally unconnected[1]. Since the original insured is neither a party to the reinsurance contract nor a third-party beneficiary to it, the general rule of law is that the original insured has no rights against the reinsurer. Most courts are reluctant to hold a reinsurer liable to any party other than the ceding company. However, there may be exceptions in case that an express intent of third party beneficiary status of the insured appeared in the terms of reinsurance contract.[2] In addition, some courts have recognized direct action against reinsurers where the reinsurer is a successor which has assumed the original insurer's liabilities to the insured.[3] For example, French direct action provision, Which stems from article 1641 of *Le Code Civil* [4], stated that third parties may proceed against the insured to establish his liability and then bring a separate *action directe* against the insurer or may proceed against both insurer and insured in the framework of the *action directe* proceedings. Under English and most states law of the U.S.A, an insured

or an assignee of the insured has no third-party right of action against a reinsurer. But some courts do recognize the insured/assignee's right of direct action when and only when they have obtained an assignment from the reinsured. By the assignment they assume the rights provided by the contract to the reinsured as well as the obligations.[5]

2. Direct Actions by Guaranty Funds

Again, third party beneficiary status becomes the theoretical base for guaranty funds to collect reinsurance proceeds directly from reinsurers. It has been contended that the guaranty funds are statutory successor to the insolvent company to whom reinsurance proceeds are paid pursuant to the insolvency clause. It turned out an unsuccessful attempt in the courts. [6]

3. Direct Actions by Ancillary Receivers

Ancillary receivers relied upon the similar bases used by guaranty funds and obtained, unsurprisingly, similar results. In Am. Re-Ins. Co. v. Ins. Comm'r[7], the court stated: "An ancillary receiver's function is to collect assets within its state and apply them for local creditor's claims in accordance with the law of that state …reinsurance proceeds are not local assets over which ancillary receiver can exercise control." [8]

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1. See *Comecticut General Life Ins. Co. v. Johnson*, 3 Cal 2d 83, 87 (1935)
2. See *Eastern Engineering v. American Reinsurance Co.*, sup. 455 A. 2d at 1236 (sup. Ct. 1990)
3. See *American Reinsurance Co. v. ICC*, 696 F 2d 1267(9th Cir. 1983). See also *Cummings Wholesale Electric Co. v. Homeowners Ins. Co.*, 492 F.2d 268 (7th Cir. 1974)
4. See *Le Code Civil*, Art. 1641 (1870)
5. *See Great Atlantic Life Insurance Co. v. Harris,* 723 S.W.2d 329, 332 (Tex. App. -- Austin 1987, writ dism'd) (Texas).
6. See *Skandia Am. Reins. Corp. v. Barnes,* 458 F. Supp. 13 (D. Col. 1978).
7. 527 F. Supp. 444 (C.D. Cal. 1981)
8. *Arizona v. Ins. Comm'r,* 682 P. 2d 431 (Ariz. Ct. App. 1984). See also *O'Malley v. Dept of Ins.*, 291 N.E.2d 907 (Ind. Ct. App. 1973).

II. Whom to sue?

1. The reinsurer being sued alone

In the event of the insolvency of the ceding company, the original insured or the claimants who have obtained judgements against the insured have the right to claim recovery directly against the reinsurer.[1] However, there are different opinions regarding whether the (re)insurer can be sued directly by the insured or other claimants if the ceding company is still solvent. In very few jurisdictions, the insured and claimants are allowed to act against the reinsurer alone even when the insurer exists.[2] Most jurisdictions, to the contrary, make the insolvency of the insurer or even the obtaining of a judgement against an insolvent insurer a condition precedent to the right of direct action.[3] The British Law Reform Commission gives an explanation regarding this majority view in its report on the draft bill of Third Parties Act 1930. The report says in section 12.9 that "*Providing for the provisions of the 1930 Act to be triggered before the occurrence of an event specified in the Act could create uncertainty and undermine the insolvency legislation. Our provisional view is that the third party's rights should continue to be conditional on the happening of one of the insolvency events set out in the Act. His rights would arise, therefore, once two events had occurred: the incident giving rise to the liability of the insured and one of the insolvency events set out in the Act.*" [4]

2. The insurer and the reinsurer being sued jointly

The joint action against both the insurer and the reinsurer receives different reactions from courts. In some jurisdictions, such a joint action is a compulsory procedure when dealing with direct action cases. To the contrary, some other jurisdictions prohibit such actions on the ground that a joint action may indicate to the jury that the ceding company has been reinsured and therefore lead to prejudice.

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1. See N.Y. Ins. Law [section] 3420 (McKinney 1985)
2. See La. Rev. Stat. Ann. [section] 22:655 (B)(1) (west 1995)
3. See N.Y. Ins. Law [section] 3420 (McKinney 1985)
4. See Law Com. Consultation Paper 152 (2001). See also Law Com. Report LC 272 (2001)

Chapter 5: Conditions precedent to direct action

I. Insolvency of the insurer

Insurer insolvencies often give rise to actions by policyholders and third-party claimants against reinsurers. The claimants argue that, when the insurers are insolvent, they step into the shoes of the insurers and actually become a party to the reinsurance contract. They seek to recover reinsurance proceeds directly from the reinsurer. Unfortunately, their actions have usually been declined by the majority courts on the ground that the reinsurance contract, except expressly provided otherwise, is not intended to benefit any party other than ceding company, or its liquidator. No privity existing between the insured and the reinsurer is usually the best theoretical evidence for courts' decision. Some claimants insisted that, at least, they should be able to act directly against the reinsurers in the status of a third party beneficiary of the contract. Yet the courts are reluctant to permit the direct action by the insured against the reinsurer based on this theory.[1]

"*Absent special language in the treaty to the contrary, an insured cannot recover against a reinsurer.*" [2] Therefore, original insureds have no direct rights against reinsurers under common law or statutory right unless the reinsurance agreements so provide. The insolvency of the original insurer does not change the nature of the reinsurer's obligation so as to permit the insured to pursue it directly. In most jurisdictions, insolvency of insurer is not sufficient to enable the insured to act directly against the reinsurer. In their view, not only is the original insured neither privy to the reinsurance contract nor a third-party beneficiary which will obtain the rights of the insolvent insurer [3] but also should he have no rights, which are not specifically set forth in the contract of reinsurance, or in a specific agreement between the reinsurer and the original insured or policyholder, against the reinsurer.

To overcome the privity requirement, a party must establish reliance by the third party on either the presence of the reinsurers or on the

reinsurer's role in the insurance coverage. This is however not what happens in reinsurance practice. In most reinsurance cases, the original insured has no knowledge about the reinsurance contract and thus can hardly convince the courts that they rely on the existence of the reinsurance. The law of New York as set forth in the leading case *"Greenman v. General Reinsurance Corporation"* [4] is that even an actual reliance by the plaintiff does not create privity for the reinsurer.

Another important theory often borrowed by the courts is the indemnity nature of reinsurance contract. In *Vial v. Norwich Fire Insurance Society,* the court held that "*Reinsurance is a mere contract of indemnity in which an insurer reinsures risks in another company. The ordinary contract of reinsurance operates solely between the insurer and reinsurer and creates no privity whatever between the reinsurer and the person originally insured . . . The reinsurer is in no respect liable, either as surety or otherwise, to the person originally insured.* [5]"

On the other hand, there are arguments about the nature of reinsurance contract when insolvency of insurer involves. A Louisiana's court held that, Where liability insurer becomes insolvent, insurer's reinsurance becomes liability insurance within direct action statute and reinsurer is amendable to direct action by third party for an injury by original insured for which reinsured insurer is liable.[6] However, this conclusion was not even adopted by the courts of its own state. *In Donaldson v. United Community Insurance Co.,* [7] The school board and the Donaldsons argued that the reinsurance agreements were tantamount to liability insurance for UCIC and, as injured parties, they were entitled to sue UCIC's reinsurers directly under Louisiana's direct action statute. The court rejected the characterization of the reinsurance agreements as liability insurance. Instead, the court concluded that reinsurance is a contract of indemnity. The court held that, absent an express undertaking to be liable to the insured, such as by means of a cut-through endorsement, a reinsurer has no liability to the insured.

Despite the dominating attitude of courts toward this issue, two unique cases are worthy of mentioning. In *Venetsanos v. Zucker, Facher &*

Zucker, [8] the primary insurer was insolvent. However, the court found the reinsurer had performed the duties typical of a primary carrier such as underwriting the risk, claims adjusting, and conducting settlement negotiations. Therefore, the court allowed a direct action against the reinsurer because it retained some control over the claim settlement decisions. The court did not set forth a bright line as to what would allow a third-party action against a reinsurer. It merely stated that if the reinsurer had "some degree of control over the decisions concerning settlement with the third-party claimant," a direct action against that reinsurer may be allowed.

Peerless Ins. Co. v. Inland Mutual Ins Co.[9] is a similar case. Pursuant to the "claims cooperation" provision, Peerless investigated the merits of the third-party claim and left the decision to settle the case with the cedent, Inland Mutual. An excess judgment resulted and the court found that Peerless and Inland Mutual were engaged in a joint enterprise and held Peerless liable to Inland Mutual for its proportional share of the excess loss.

Despite the claims by the original insured, in the event of insolvency of the insurer, the reinsurance proceeds are generally paid to liquidators of the insurer regardless the indemnity nature of the reinsurance contract, given that there is a provision providing so in the reinsurance agreement. Most states have adopted statutes, regulations, rules or practices that prohibit credit for reinsurance unless the reinsurance agreement contains a provision stating that in the event of insolvency of the ceding company, the reinsurer shall pay reinsurance proceeds to the domiciliary liquidator based on the liability of the ceding company, as established in the liquidation proceeding, regardless of whether or not the liquidator can pay fully such liability.[10] such a clause is often called the Insolvency Clause, which is contained in most reinsurance agreements today. It is generally worded as: *"reinsurance proceeds will be preserved for the benefit of all insured, creditors of the insolvent insurer"* and thus provide that *"the claimants, and reinsurer shall pay reinsurance proceeds to the domiciliary liquidator based on the liability of the ceding company, as established in the*

liquidation proceeding, regardless whether or not the liquidator can pay fully such liability." [11]

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1. See *Leff v. NAC Agency Inc.*, sup. 639 F supp at 1429.
2. See *Skandia America Reinsurance Corp. v. Schenck*, 441 F. Supp. 715 (S.D.N.Y. 1977), *citing General Reinsurance Corp. v. Williams*, No. 75-1336 at 3 (S.D.N.Y., March 23, 1976).
3. See *Cummings Wholesale v. Home Owners Ins.*, supra, note 1, 492 F.2d at 271 (F.1983).
4. See 262 N.Y. 701, *aff'd*, 188 N.E. 128 (N.Y. 1922)
5. See 257 Ill. 355, 100 N.E. 929 (1913)
6. *See Fotenot v. Marquette Casualty* 235 So.2d 631 (La.1971).
7. See No. 98-1187, 1999 WL 59687 (La. Ct. App. Feb. 10, 1999)
8. See 638 A.2d 1333 (N.J. Super. Ct. App. Div. 1994)
9. See 251 F.2d 696 (4th Cir. 1958)
10. See *Arrow Trucking Co. v. Continental Ins. Co.*, 465 So. 2d 691 (La. 1985)
11. Semple and Hall, *the Reinsurer's liability in the event of insolvency of a ceding property and casualty insurer*, Tort and Insurance Law Journal, Vol. XXI, No. 3,407,409 (1991).

II. The claimant must be a judgment creditor

Direct action statutes also require that the third party be a judgement creditor having already secured judgement against the insured party. For example, under New York insurance statutes, injured third parties are allowed to bring a direct action against the tortfeasor's insurer to recover up to the policy coverage limit, but only when the injured parties have obtained a judgment against the insured tortfeasor. This provision reflects the general rule of common law in respect of direct action: only when the claimant becomes a judgment creditor of the insured may he obtain the status of third party beneficiary and commence a direct action against the insured tortfeasor.

Although the statutes, New York insurance statute for example, give an injured claimant who has obtained a judgement against the insured a direct right of action against the liability insurer, their statutes typically do not provide for the joinder of the insurer as a defendant in the initial tort case against insured. The insurer, therefore, does not get involved until after a jury finds in favour of the third party.

Occasionally, direct action statutes require that the insured party be insolvent before the injured party may proceed against the insurer as a judgement creditor. [1]

1. See N.Y. Ins. Law [section] 3420 (a)(1) (McKinney 1985)

Chapter 6: A glance at Major Jurisdictions

I. U.K.

a. The third parties (Rights against Insurers) Act of 1930 [1]

The Act was originally "*introduced to give relief to the increasing number of innocent people who suffered at the hands of the fast-growing band of motorists who in those days had a habit of going bankrupt at the wrong moment.*"[2]

Under the Act, the rights of a bankrupt insured are transferred to and vested in the injured third party.[3] The statute, in effect, eliminates the common law privity requirements so than it cannot be raised as a defense to an action brought by a stranger to the contract.[4]

This Act also diminishes the distinction between indemnity and liability insurance. The impact of this Act on P. & I. insurance will be discussed in the chapter on "P. & I. Clubs".

b. The Contracts (Rights of Third Parties) Bill 1999 [5]

The principle that a contract cannot confer rights on a non-party[6], known as the Privity theory, has been frequently criticised by English courts and other common law jurisdictions while it still affects the courts' decisions, more or less.

This philosophy probably will be, however, changed to a certain degree by the Contracts (Rights of Third Parties) Bill 1999, which aims to end the criticized principle of limiting who can sue in English courts to enforce contracts.

The main provision, Section 1, says that a person not party to a contract (a 'third party') may in their own right enforce a term of the contract "*if the contract expressly provides that they may; or, if the term purports to confer a benefit on them, unless, on a proper construction of the contract, it appears that the parties did not intend the term to be enforceable by the third party. The third party must be expressly identified in the contract, by name, as a member of a class or as answering a particular description, but need not be in existence when the contract is entered into.*"[6]

Section 2 of the Bill provides that, where a third party has a right under Section 1 to enforce a term of the contract, the parties to the contract may not rescind it or vary it to extinguish or alter the third party's entitlement without the third party's consent.

As to reinsurance, it is held that the insured is not entitled a right to enforce against the reinsurer unless the reinsurance policy contains specific provision that the reinsurer should pay the insured directly.

When the reinsurance policy does not expressly provide for a provision that entitles the insured to act directly, the policy may still be structured in such a way that its terms could be read as purporting to confer a benefit on the insured and thus satisfies the requirements of Section 1. This may be more likely where an insurer reinsures each risk individually.

In the insolvency of the insurer where a cut-through arrangement has been agreed previously, the Bill shows no reluctance to reject the insured's direct action against the reinsurer. Neither does the Bill show a clear intention to support such an action though.

Therefore, the result of the insured's race with all other creditors of the insolvent insurer depends varies on a case-to-case basis. The Bill, the reinsurance contract, as well as insolvency law should all be taken into our consideration. Moreover, in the cut-through situation, the factor of time is essential for the success of a direct action. If the insurer, through its liquidator, succeeds in being paid the reinsurance sums before the insured does, a court would be unlikely to require the reinsurer to pay the insured. Otherwise, the reinsurer will have paid twice. The insured will then find that the reinsurance monies are distributed among the insurer's creditors, such that the insured may not recover 100%, unless the insured can successfully argue through application of case authorities outside the insurance field that the last insurer holds the monies on trust for the insured.

II. Canada:

In Canada, reinsurance is generally considered a contract or policy of insurance between the direct insurer and a reinsurer, wherein the latter

agrees to indemnify the ceding company with respect to some portion of the risk assumed under the original policy of insurance. The reinsurer does not appear as a party to the original policy and there are no rights or obligations between the reinsurer and the original insured. In another case, the court stated that "*in the absence of special provisions, the obligation of a reinsurer was to the reinsured alone, and, consequently, the proceeds of the reinsurance policies were payable to the liquidator, and not the injured persons.*" [7]

Insurance law in Canada is governed by provincial legislation, but there is considerable uniformity across the provinces. A third party must have obtained a judgment against the insured and the insured must have failed to satisfy that judgment before he can proceed against the insurer.

As to marine reinsurance, since admiralty law falls into the scope of federal legislation, direct actions against marine reinsurers are thus governed by the federal law, i.e. the Marine Insurance Act.[8] There isn't much difference between general insurance and marine insurance regarding direct action; the latter is probably even harder on the claimants.

III. Quebec:

Regardless the fact that direct actions against marine reinsurers are within the scope of federal jurisdiction in Canada, the provincial courts have shown no different attitude toward these actions. Some of them went even further in restricting the original insured's rights against the reinsurer. For instance, a Quebec court concluded, after carefully examining the facts and circumstances of the case, that a contract of reinsurance with participation in the profits does not constitute a contract of partnership. The injured party could not exercise the rights against the reinsurer without special provisions in the reinsurance contract.[9]

IV. United States:

The common law of the United States does not provide for direct actions. Likewise, the federal admiralty law does not supply such

actions. There are no federal statutory provisions concerning direct actions. On the other hand, the principle of privity of contract is generally observed in US law, which also maintains the distinction between liability and indemnity insurance, a distinction which has been blurred in English law. However, the effect of direct action statutes which have been introduced in some states may be to remove this distinction. It is settled law in the United States that, in the interest of protecting the welfare of its citizens, a state may impair the contractual relationship between the insurer and the insured by permitting direct actions. This is exactly what has been done by those states with direct action statutes - the states have legislatively overridden the intended effect of no-action clauses.

As a result, the rights of third parties against insurers vary greatly from state to state. A few states and Puerto Rico have direct action statutes that provide the victim with recourse against the insured's underwriter. For instance, under Louisiana law, Louisiana, the claimants even have a right of direct action against the (re)insurer without having first to establish the liability of the insured/insurer. In others, they must establish the liability of the insured first. Their right of action may or may not be dependant on the insolvency of the insured. In many cases, such statutes were introduced because of concern over the inclusion of "no action" clauses in insurance contracts. Additionally, Florida may or may not have a certain judicially created right similar to that of a direct action. Except for these jurisdictions, claimant victims have no definitive legal right to subrogation or direct action against the shipowner's insurer. [10]

V. France:

French courts have developed the concept of *action directe* to allow a third party to proceed against the insurer of the person who caused him harm. Article L124-3 of the Code des Assurances provides [11]:

The insurer cannot pay to a party other than the wronged third party all or any part of the sums due by him until the third party has been

indemnified for losses arising from the wrongful act causing the liability of the insured.

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1. See *The Third Parties (Rights Against Insurers) Act*, 1930, 20-21 Geo. V. ch. 25 (Eng.)
2. See Christopher Hill, *Introduction to P&I*, 122 (2d ed. 1996)
3. See Third Parties Act, U.K.1999, ch. 31, Section I (2)
4. See Hill, supra note 2, at 122.
5. See Third Parties Act, 1999, U.K.1999. ch. 31
6. See Ibid, ch. 31, Section 1.
7. See *Canadian International Marine Underwriters Ltd. v. Symons General Insurance Co.*, 1988 A.C.W.S.J. Lexis 22926.
8. See *Treverton v. Superintendant of Insurance for Canada,* 1 W.W.R.476 (Man.C.A.), app. Den., (S.C.Can. 1985); also see Marine Insurance Act, 1993. R.S.C.1993
9. See *KUNGL v. Great Lakes Reinsurance Co.*, 152 N.E.2d 220 (Ill. App. Ct. 1959)
10. See *Pocatello Industrial Park* v. *Steel West Inc., 819 F.2d 120, 123, 1987 AMC 2975 (5th Cir. 1987)*
11. Le Code des Assurances (1992), art. L124-3

Chapter 7: Direct action against P. & I. Clubs ---A comparison of U.S.A. and U.K.

Introduction

An injured third party who is not privy to the contract of insurance between the wrongdoer and the wrongdoer's insurers has no rights against those insurers. Consequently, prior to the enactment of the 1930 Act, an injured person was not entitled to look to the insurance proceeds for payment of his damages even when the assured wrongdoer, by virtue of insolvency, was unable to satisfy a judgment debt incurred as a result of his wrongdoing. In the event of insolvency, insurance proceeds became part of the assured's general assets, and a person injured by an insolvent assured would rank in the insolvency proceedings as a mere ordinary creditor. The ***Third Parties (Rights Against Insurers) Act 1930*** (the Act) changes the philosophy concerning liability insurance, in supporting the view that insurance proceeds should be considered to be for the benefit of the injured party rather than for the protection of the assured. The same spirit is also reflected by certain American legislations such as the Louisiana's Direct Action Statute. The enactment of this "victims' charter" in 1930 had fundamental implications for shipowners' P. & I. Associations. However, P. & I. reinsurance is not within the scope of the 1930 Act. It was mentioned, instead, in the Third Parties Act 1999, which is about to be replaced, if granted by the parliament, by the British Law Commission's drafted bill 2001. The latter, like the 1999 Act, does not shut its door to reinsurance.

I. The Third Parties Act 1930—Direct Action Against P. & I. Clubs in U.K.

Prior to the enactment of the 1930 Act, in the insured's insolvency, the policy money became part of his general assets and even where the policy money formed the whole of the assets the third party ranked as an ordinary creditor only.

However, the enactment of the 1930 Act enables or, at least make it possible for, the injured third party to bring a direct action against the insurer and pursue the whole policy proceeds. Unfortunately, it was

not clear whether the Act applies to P. & I. Clubs on the enactment of the Act. The London P & I clubs have not expressly acquiesced in the applicability of the Third Parties Act to marine P & I insurance because England's highest court has not declared it applicable. Nevertheless, there are intermediate appellate court decisions holding or at least assuming that the Act is so applicable. Yet there were a number of difficulties in applying the Act to P. & I. Insurance.

1) Section 1(1) of the Act determines its provisions only apply to "contracts of insurance". Therefore, whether the Act is applicable to P. & I. Insurance depends on whether the relationship between a club and a member could be considered a "contract of insurance". It has been held in a number of cases that the arrangements between a club and its members are contracts of insurance within ordinary legal terminology and within the meaning of section 1(1) of the Act.[1]
2) The possibility for a claimant to bring an action against foreign members of P. & I. Clubs has to be determined. The difficulty in this stage is whether a winding-up order against a foreign assured can be obtained in domestic courts. Recent cases have indicated, provided that there are assets available within the jurisdiction or at least the possibility that a substantial benefit to the creditors might accrue, that a winding-up may be ordered.[2]
3) Insured must establish his liability to the claimant by judgment or arbitral award before he claims the right of indemnity. [3]

Before a third party action is permitted against a company, under section 1.1(b) of the Act, one of four "events" must first transpire, if the company is not already bankrupt or has not already made a composition or arrangement with its creditors:
(1) There must be a winding-up order made; or (2) A resolution for a voluntary winding-up passed; or (3) A receiver or manager of the company's business appointed; or (4) A taking possession of property subject to a debenture secured by a floating charge.

In addition, before the 1930 Act can be utilized, the cause of action must arise. Most club rules provide that if any difference or dispute arises between the member and the association, it must be referred to arbitration. Some rules go further and require a prior referral of the difference or dispute to the association's directors or a committee for its resolution or decision. The High Court of Justice held that, based upon well-settled English law, the requirement of a prior submission of the dispute to a committee and then to arbitration is still valid and enforceable, despite the enactment of the Act of 1930. The committee or directors must, of course, exercise their discretion fairly, in good faith, and not capriciously. They may, however, consider and protect the interests of the other members of the club who are, of course, the putative payors of the claim.

Furthermore, the third party must have sued the insured to judgment before he can sue the insurer under the Act of 1930, unless there is a settlement by the member, with the written consent of the club.

1. See *Indemnity Society Ltd. Etc.*[1939]4 All E.R.570, 595. See also *In re Allobrogia Steamship Corporation* [1979] Lloyd's Rep. 190
2. *See Re Eloc-Electro Optieck* [1981] 2 All E.R.1111.
3. See *Post Office v. Norwich Union Fire Ins. Co.* [1967] Lloyd's Rep. 216

II. Contracts (Rights of Third parties) Act 1999 – P. & I. Clubs as Reinsurers

1) P. & I. Club reinsurance

Occasionally, the loss occurred to a shipowner or a charterer can be so astronomical that even its insurer, the club, feels hard to handle it alone. To prevent this from happening, a number of P. & I. Clubs pooled their claims in one reinsurance arrangement, which will function when the claim is in excess of a specified figure. As we know, such a reinsurance arrangement is called Excess of Loss reinsurance, or an Excess Loss Pool.

Unsurprisingly, this reinsurance arrangement has been international in nature from the very beginning. About 19 clubs worldwide have joined the arrangement and they constitute the so-called International Group.

The question of whether an injured third party is entitled to act directly against its reinsurer, the International Group, was not mentioned in the Group's arrangement. In fact, the 19 clubs, as insurers, have rarely failed to pay the claims and therefore the insureds will never be able to act against the Group, nor do they need to.

2) The 1999 Act

In the § 1.8 of the Law Commission and the Scottish Law Commission report No.272, it has been said that "*(i)t is possible that, in England, third parties may in the future derive some benefit from the Contracts (Rights of Third Parties) Act 1999.*"[1] It "*may have an important effect in the context of reinsurance contracts with cut-through clauses by allowing direct claims by the insured against the reinsurer.*"[2]

III. Pay-To-Be-Paid Rule

When bringing an action against the insurer, the third party cannot "*pick out the plums and leave the duff behind*" (Harman L.J.). All defences available to insurers will still be available against the third party claimant, including the Club Rules. It could be said that a third party claimant is bound by the Club Rules once he steps into a member's shoes.

Under Club Rules it is a condition precedent to a member's rights of recovery that his calls are fully paid, the so-called "pay to be paid"

rule. The availability of this defence against the third party has been argued in a number of English cases. In the "Fanti"[3], the court held the pay-to-be-paid rule should be struck down due to the impossibility for the third party of paying himself, which is a precondition to making use of the member's rights against the insurer according to the contract, whereas the court of "Padre Island"[4] insisted that as a subrogee of the member, the third party had no right to claim before the condition of the contract being performed. In the Court of Appeal the two cases were brought together and the "pay to be paid" rule was struck down on the ground that the requirement of pay to be paid had become impossible. On the other hand, the court didn't recognize the claimant's argument concerning the conflicts between the pay-to-be-paid rule and section 1(3) of the Act. This judgment was soon reversed by the House of Lords. The court held that on the ordinary and natural construction of the Club Rules, members were not entitled to be indemnified by the club unless and until the members themselves had first discharged liabilities in respect of which they sought an indemnity from the club. The pay to be paid rule should not be struck down by section 1(3) of the Act, nor should it be nullified merely because such a contractual provision cannot be performed.

In the United States, prior to the enactment of a few states' direct action statutes, the pay-to-be-paid rule was normally upheld. Justice Frankfurter, in his concurring opinion in *Watson v. Employers Liability Assurance Corp.*[5], underscored the importance of the "no-action" clause. His opinion emphasizes that such clauses are vital to the insurance contract and, thus, should be respected by the courts.

The indemnity or pay-first provision in most P & I contracts will preclude a direct action by a victim claimant. Nevertheless, as more states adopted their direct action statutes, such provisions have often been overruled.

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1. Law com. No. 272; Scot. Law com. No. 184, § 1.8 [2001]
2. Ibid.
3. 2 App. Cas. At 29; [1990] 2 Lloyd's Rep. 191
4. Padre Island, the [1984] 2 Lloyd's Rep. 408
5. 348 U.S.at 322-23

IV. Policy provisions and the Governing law of P. & I. Insurance

Some of the important and usual provisions in a P. & I. Policy are the following: Cesser of insurance; set-offs; appointment of counsel; control of the litigation; cooperation of the assured; the "prudent uninsured shipowner" obligation (to defend oneself as one would do if uninsured); prohibition against settlements without club consent; forbearance or indulgence by the manager in the enforcement of the rules (providing that such will not constitute a waiver of other provisions); indemnity (the member must first pay any settlement or judgment before the club is obligated to reimburse); referral of disputes to the club's committee, directors, or board; referral of disputes to arbitration; and the choice of law made applicable to these rules by the contracting parties.

Due to the traditionally recognized importance of London in P & I insurance, it is generally assumed that English law has been specified to govern the agreement even when it was actually performed in another country. In the landmark case of *London Assurance v. Companhia de Moagens do Barreiro,* the United States Supreme Court wrote:

In Scudder *v.* Union National Bank[1], the broad statement of the foregoing cases was somewhat narrowed, and it was stated that *the law prevailing at the place of the performance of a contract regulated matters connected with its performance, and that matters bearing upon the execution, interpretation and validity of the contract were determined by the law of the place where it was made. ….The interpretation of the contract was intended by the parties to depend upon the principles of English law as they obtained and were recognized in England by the usages prevailing at Lloyd's. This is what the parties expressly stipulated for, and it is no injustice to the company to decide its rights according to the principles of the law of the country which it has agreed to be bound by, so long as, in a case like this, the foreign law is not in any way contrary to the policy of our own.* [2]

Occasionally, the policy will be silent on the subject of applicable law. Absent a choice of law made by the parties, the court's choice-of-law rules required the application of the law of the state or country having the most significant connection with the insurance contract. Under

the significant connection test, the following elements are usually taken into consideration: the place of contracting, the place of negotiation, the place where the policy is issued and delivered, the location of the parties, and the place where most of the events upon which the suit is based took place. Moreover, when faced with a choice of applying English or American law, American courts have shown no reluctance in applying English law. Therefore, unless the intent of the parties is quite clearly to the contrary, it would seem that marine insurance policies written in London would be governed by English law and those written in the United States by United States law.

V. Direct action against P. & I. Clubs in U.S.A.

Most P & I insurance contracts contain an indemnity or pay-first clause. This clause provides that the insurer is not bound to pay until and unless the insured himself has paid. The insurance company will contend that this provision is an essential term of the agreement whereas the third party will argue that the clause is unreasonable and impossible to realize in the event of the insolvency of the insured. The reality is that in most American jurisdictions where there is a direct action statute the pay-to-be-paid provision (no action or pay-first clause) has been nullified by the direct action statutes. Direct Action against P. & I. Clubs appears more recognizable by American courts.

Being a judgment creditor is the only requirement for a third party to claim against P. & I. Clubs in many states. Louisiana Direct Action Statute, for example, permitted an injured person to sue P. & I. Clubs directly.[3] The pay-to-be-paid rule is often considered a violation of public policy[4] and therefore void under statutes. In *Olympic Towing Corporation v. Nebel Towing Co.*[5], Louisiana court held that P. & I. Policies are just like any other marine insurance and may be directly attacked by injured third parties. The court mentioned neither the distinction between liability insurance and indemnity insurance nor the traditional concept that indemnity insurance is solely for the benefit of the assured. Similarly, another Louisiana court also ignored the fundamental difference between liability insurance and indemnity

insurance in *American Sugar v. Vainqueur Corp.*[6] Some U.S. jurisdictions such as New York and federal courts have doubted or criticized these decisions.[7]

Recent cases have added uncertainty to the attitude of courts towards direct action against P. & I. Insurers. The arguments are mainly about whether P. & I. Insurance is "Ocean Marine Insurance" which would be excluded from direct action statutes.[8]

VI. Conclusion

Before determining whether the Club Rule of pay-to-be-paid an available defence to P. & I. Insurers, we should be aware of the distinction between the third party's rights based upon a statute and the rights based upon a mere contract. In other words, a third party who obtains his rights against an insurer from a source outside the contract, i.e. a statute, may, in my opinion, acquire the rights of the assured in a manner modified by the statute. Once the basis of the third party has been determined, we have to examine whether the contractual provision alters the third party's substantial rights under the statute. Any provision or Rules altering the rights of the third party who based his action upon a basis other than only the contract should be considered void.

In the event of the insolvency of a member, the shipowner has a duty under the insurance contract to cooperate and to vigorously defend himself in order to minimize any expense or liability for which he is insured by the club. Failing in that duty, he may be deprived of the recovery or a part of it determined by the amount that would have been paid out if the member had defended himself, as he would have been obliged to do had he not been insured with that club.

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1. See 91 U.S. 406 (1943)
2. See 244 U.S. 239 (1952)
3. See *Cushing v. Maryland Cas. Co.* [1952] A.M.C. 1803, 198 F.2d.536 (5th Cir.1952)
4. *See Saunders v. Austin W. Fishing Cop.* [1967] A.M.C. 984; 224 N.E. 2d. 215
5. 419 F.2d 230 (5th Cir.1969)
6. A.M.C.405
7. See *Miller v. American S.S Owners mutual P. & I. Co.* 509 F. Supp. 1047-S.D.N.Y [1984]
8. *Grubbs v. Gulf International Marine, Inc.* A.M.C. 164 (5th Cir. 1992)

Chapter 8: Limitation of liability

Introduction

If the reinsurer is viewed as liable to the original insured or injured third party, then to what extent the reinsurer should be liable? We know that the shipowners (insureds) take limited liability for marine casualties involving their vessels under certain circumstances, i.e. without privity to or knowledge of the occurrence of casualties. Can the reinsurer take advantage of this limitation of liability? There are different answers to this question. Some courts held that the (re)insurer's liability should not be affected by the limitation proceedings since such a defense is personal to the shipowners/bareboat charterers.[1] In the *Nebel Towing* case[2], the court reasoned that limited liability is available only to a shipowner since "*limitation attaches via his status as a shipowner, it is a personal defense under Louisiana law and is unavailable to insurer by operation of article 1801.*" To the contrary, some other courts held that the limitation of liability is not a personal defense to the shipowners/bareboat charterers and is therefore available to the (re)insurers as well. In the *Crown Zellerbach*[3], the court examined the nature of limitation of liability and held: a personal defense must provide its holder with an absolute immunity which is "*extended to each of the respective classes and to all of the members of each class.*" In the *Alcoa Steamship*[4], it was further held: since limitation under the federal law is not an absolute immunity, nor is it available for all owners or operators of vessels for all liabilities, limitation can therefore be clearly distinguished from personal defenses on this basis. Both of the opinions focus on the point that whether limitation of liability is a defense personal to the shipowner-assured, and thus available or unavailable to P&I underwriters.

The precedents mentioned above involve only insurance arrangement rather than reinsurance. As to the latter, the applicability of limited liability will not be affected by the reinsurance of the original policy if the nature of limitation defense is the only factor determining the answer to our question. If the limited liability is not a personal

defense to the shipowners/bareboat charterers, it will be available to the insurer as well as the reinsurer.

On the other hand, the nature of limitation liability should not be the only approach to the conclusion since it considers merely the admiralty side of this problem and ignores the insurance side. (Re)Insurance, in its nature, is to let the insured recover its loss or liability. Thus, it is a common sense that the (re)insurer should be liable for no more than the loss or liability of the insured. Otherwise there will be no reason for insurers to exist. Consequently, the (re)insurers should be liable for no more than the payments made or to be made by the shipowners/bareboat charterers under the limited liability. In fact this is a general rule of P. & I. clubs practice. A practical method for the (re)insurers to enforce this rule is, even in those places where insures are not entitled the right to limitation which is viewed as personal defense, to limit its liability by contractual arrangement.

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1. See *In re Independent Towing Company Inc, the ITCO III*, 2 Lloyd's rep 469 [1965];
2. *Olympic Towing Corp. v. Nebel Towing Company Inc.*, (1970) 397 US 989; [1971] AMC 815, distinguished.
3. Crown Zellerbach Corp. v. Ingram Industries Inc., 783 F 2d. 1926; 93 L.E.D. 2d 40 107 S. Ct. 87 (1986)
4. Alcoa S.S. Co. v. Charles Ferran & Co., 383 F. 2d 46 (5th Cir. 1967)

I. An Overview of Limitation Proceeding

The limitation of liability permits an shipowner or a bareboat charterer to limit its liability in a marine casualty involving multiple claims to the value of the vessel and her freight then pending, so long as the owner or the charterer is without "privity or knowledge" to the negligence or unseaworthiness which caused the incident. The limited liability provides the shipowners with a valuable procedural tool which, under certain circumstances, can limit or even eliminate the liabilities resulting from a marine casualty involving their vessels.

The earliest legislation in England relieved the burden of shipowners with respect to loss or damage to goods on board the ship by fault of the master or mariners, or by fault of the owners themselves without the privity or knowledge of it, further than the value of the ship and her appurtenances, and the freight due or to grow due for the voyage, and, if greater damage occurred, it should be averaged among those who sustained it. In 1958 limitation provisions in England were extended to allow limitation to "*any charterer and any person interested in or in possession of the ship, and in particular, any manager or operator of the ship*"[1] for losses in which the master and mariners had no part, their negligence, and to damage done by collision, while there was an entire exemption of liability for loss or damage by fire, or for loss of gold and jewellery, unless its nature and value were disclosed. In all these statutes the liability of the owner was limited to his interest in the ship and freight for the voyage.

The American congress enacted its new Limited Liability Act[2] in 1964. Unfortunately, this Act has somehow become a luxury for the owners of vessels because most merchant vessels today are owned by corporations whose shareholders did not bear personal liability for losses involving the vessels. Moreover, corporations also had available to them the ability to spread the risk of a catastrophe at sea through the purchase of insurance.

II. Direct action and Limitation of liability

Now we come to the question whether a (re)insurer can limit its liability under limitation legislation in a direct action litigation. The best solution seems to be, in the absence of a specific legislation, providing an express intention to limit the insurer's liability in the terms of their insurance contracts. However, the public policy backing up the direct action theory indicates that liability insurance is for the benefit of injured third party rather than for the protection of the insured. As a result, a full recovery of the injured person supersedes the insured's right of limiting its liability.

The direct action theory does not make as much sense when it is used to circumvent limitation of liability.

Generally, marine insurance policies do not provide limit of liability except in respect of chartered entries and oil pollution claims. This is particularly so in P. & I. insurance, which is the major form of marine insurance. However, the clubs do provide that their liabilities are limited to the amount in which the member should be able to limit its liability. In other words, the clubs do not set a limitation of liability for any claim but they will be responsible for no more than the limited liability of the members.

This has become a Club Rule which may be reflected in every standard P. & I. policy. The rule said the club will not be liable in excess of the amount to which the member could have limited its liability even if he did not do so. Moreover, the right to limitation cannot be prejudiced by agreement. To deal with the possibility of direct action clubs provide in their recommended clauses that they will be entitled to rely upon a member's right to limit liability and shall not be liable to pay claims in excess of such a limit.

III. Convention on Limitation of Liability for maritime claims 1976 [3]

Under the 1976 Convention Limitation regime, Article 1 provides the shipowners, which includes the owner, charterer, manager and operator of

a sea-going ship and salvors, are entitled to limit liability. It goes on to provide that if any claims are made against any person for whose act, neglect or default the shipowner or salvor is responsible, such person shall be entitled to avail him of the limitation of liability provided for in the convention.[4] A major innovation in the new convention is that limitation is also available to an insurer of liability for claims subject to limitation in accordance with the rules of the convention and the insurer is entitled to the benefit of the convention to the same extent as an assured. This will be of significant importance to clubs who are now entitled to limit liability to the same extent as their members where, in 1976 Convention states, they are proceeded against directly. It is in this regard important that Club Rules provide that it is a condition precedent to a member's right of recovery from the club that the member must have been found liable as a shipowner. By this formula the club will ensure that it is covering a member's liability only in the capacity in which he is prima facie entitled to limit liability and not in some other capacity such as a manufacturer, oil producer or such like.

IV. Contractual provisions enforcing the club rule of limited liability

Several provisions are often utilized in addition to the club rule of limited liability. For instance, a provision may state if the club has taken over only a proportion of the member's liabilities, the club's obligations are to be limited to cover a corresponding proportion of the assured's amount of limitation. Such a provision will protect the clubs particularly in countries where the right to limit liability is viewed as a personal defense to the shipowners. The courts in these countries will, however, allow directly sued insurers to rely upon their assured's right to limitation under contract on the ground that a contractual right to limit is not a personal defense or a matter of public policy but instead is a private arrangement between insurer and assured.[5] For the clubs, to claim the contractual limit as agreed in the insurance policy risks nothing more than what to claim the statutory does.[6] In *Crown*

Zellerbach[7], the court overruled *Nebel Towing*[8] and held that limitation was not a defense personal to the shipowner.

Another common provision often provides that the club will indemnify a member in respect of his liabilities arising from contracts for the carriage of cargo provided that he has contracted on terms no more onerous than those applicable under The Hague or Hague-Visby Rules.

In most cases, if a member fails to take advantage of the right to limitation, he will have to prove that such a failure is reasonable or the clubs will be relieved.

V. The view of Limitation as a defense personal to the shipowners

The reasoning of the *Crown Zellerbach* might be seriously challenged by arguing that the distinction between a statutory defense and a policy defense makes little difference in light of the Direct Action Statute, which voids any terms in a policy which are against public policy.

As we have discussed, especially in the jurisdictions where their direct action statutes will nullify the contractual provisions that violate public policy, the determinitive issue is the nature of the limitation defense: whether limitation of liability is a defense personal to the shipowner. The court of *Crown Zellerbach* decided that limitation of liability was not a personal defense under Louisiana law. Interestingly, the same opinion had appeared in the *Nebel Towing* dissent: "The right to limit liability is not one which inheres in the "person" of the shipowner. It is available to a shipowner of a specific vessel under some circumstances. It is not available under others. It does not turn upon his status as shipowner. And it is not a right which he as shipowner can claim. The right to limit inheres in the nature of the transaction giving rise to the underlying obligation and the shipowner's participation in it under the concepts of "privity or knowledge."

Because limitation is not available to shipowners as a class, but rather depends upon the nature and character of the underlying

transaction, limitation tends to be much more a defense that arises "from the nature of the obligation."

1. Limitation Act 1958, Ch.1 s.2 (Eng)
2. 46 US Code, [1964] sects 183(a), 186
3. 46 U.S. Code [1964] s.181
4. Art. 1(4)
5. See Alcoa S.S. Co. v. Charles Ferran & Co. 383 F.2d 46 (5th Cir.1967)
6. Crown Zellerbach Corp. v. Ingram Industries Inc., 783F 2d. 1926; 93 L.E.D.2d 40; 107 S. Ct.87 (1986).
7. 783 F 2d. 1926; 93 L.E.D.2d 40; 107 S. Ct. 87 (1986)
8. 397 US 989; [1971] AMC 815, distinguished

Chapter 9: The applicable law to direct action

Introduction

The proper law is a system of law which the parties intended their contract to be governed or, where the intention is not expressly stated, by that system which it can be inferred the party did intend to apply. If neither of them can be relied upon, the law that has the closest and most real connection with the transaction applies. It is true that, except in very few cases where the contractual arrangements conflict with the law, the intention of parties is always paramount. A practical and satisfying methodology sorting out previous theories and practices in respect of choice of law has been suggested by William Tetley in his *International Conflict of Laws*.[1]

As to marine reinsurance, few disputes are brought to court between the insurer and the reinsurer because most reinsurance contracts contain arbitration clauses and, in many jurisdictions, arbitration has to be tried prior to the litigation process, as a matter of procedure. However, a direct action by the original insured against the reinsurer will not, given that there is no contractual relationship between them, involve any arbitration arrangement to resolve their disputes if they choose not to. Therefore, a proper choice of law is essential.

This chapter examines the impact of United Kingdom marine insurance law and practice on the law and practice in other common law countries. The legal regimes applicable to marine insurance in civil code countries and some important differences between common law and civil code jurisdictions are briefly summarised. The chapter concludes with discussion of the harmonisation of national marine insurance laws and other relevant international reforms.

A: Common law countries

I. U.K.: Third Parties Act 1999[2]

The draft Bill prepared by the Law Commission of England in 1999 listed a few criteria which could be used to determine the applicability

of the Act to cases with a foreign element. To support its view, the Commission goes on explaining that "*the ability of a third party to rely on the Act will depend on both its applicability and on whether or not the court in which he is proceeding has jurisdiction over the insurer. We consider whether the fact that a UK court has jurisdiction over the insurer should itself be the criterion for the applicability of the Act or whether its applicability should depend on other factors.*" [3]

The criteria includes [4]:

(i) The insured has been declared bankrupt or wound up in this country;

(ii) the insurance proceeds are payable in this country;

(iii) the law governing the insurance contract is English or Scottish law;

(iv) the courts have jurisdiction in respect of the tort or delict or breach of contract committed by the insured;

(v) the insured is subject to the jurisdiction of a UK court.

II. Europe: The Rome Convention[5]

The purpose of the Rome Convention is to harmonize the law in the European Community in relation to conflict of laws concerning contracts. The basic principle of the Convention is that the contract is to be governed by the law chosen by the parties in accordance with the restrictions set out in the Convention. Article 3(4) of the Convention provides that the validity of the choice of law clause shall be determined in accordance with Article 8, 9 and 11. Article 8 provides that the validity of a contract, or of any term of a contract, shall be determined by the law which would govern it under the Rome Convention if the contract or term is valid. Article 3(2) provides that the parties may at any time agree to subject the contract to a law other than that which previously governed it. The choice may be express or implied by the terms or the circumstances of the contract.[6] Where the parties have not chosen the applicable law, Article 4(1) provides that the contract shall be governed by the law of the country with which it is most closely connected.

III. U.S.: New York v. Louisiana

The USA does not have federal marine insurance legislation but its case law has been in close accord with United Kingdom legislation and case law. Federal admiralty law in the USA, including that related to marine insurance, has been greatly influenced by the English common law and federal courts in the USA have explicitly sought to keep federal marine insurance law in harmony with English law. However, the law in the USA has been complicated by the decision in *Wilburn Boat v Fireman's Fund Insurance Co* [8], which resulted in state rather than federal law (including laws relating to general insurance) being applied to policies of marine insurance. As a consequence American law increasingly diverges from the law in the United Kingdom. These differences include variations with respect to misrepresentation, non-disclosure, and express and implied warranties.

U.S. does not have a uniform direct action statute. The direct action against marine reinsurer is governed by state law. Louisiana apparently has the most strict provisions for the reinsurers, which, unfortunately, apply to not only the cases with the reinsurance agreements signed in Louisiana but the ones with the major transactions conducted in Louisiana. In other words, even those insurers and reinsurers who are from other state may not be able to escape Louisiana law, i.e. the Direct Action act. New York is another state with a more conservative and straightforward direct action legislation.

There has been debate on whether or not the Direct Action Statute applies to maritime locales particularly when personal injuries involve.[9] However, it is rather clear that the statute does not apply to P. & I. insurance and reinsurance. Therefore, in the absence of a uniform federal law, the law chosen by the parties is generally held applicable. In most cases, U.K. law is either expressly intended or implied to be the one that rules.

It has been suggested that the USA enact a federal marine insurance Act or that the American Law Institute undertake to produce a

Restatement of the law of marine insurance. The Maritime Law Association of the United States is currently embarked on a project to collect, study and synthesize the case law and applicable state statutory law into a plain statement of the maritime law. At the conference of the Comité Maritime International (CMI) in February 2001 Graydon Staring said that the issue of reform of the US law of marine insurance had been raised by individuals and interested groups rather than with the endorsement of the US Maritime Law Association. He noted that it was unlikely that formal legislative reform would be undertaken at a federal level and warned against the enactment of state legislation that varied from one state to the next. He added that the US Maritime Law Association held the view that formal international marine insurance reform by means of any type of international instrument was not appropriate at this stage.

IV. Canada

The 1993 Canadian legislation was enacted in response to a decision of the Supreme Court of Canada in the *Triglav* case [10], which held that a contract of marine insurance is a contract of maritime law clearly within the jurisdiction of the federal parliament as part of navigation and shipping. Marine insurance had previously been governed by provincial marine insurance Acts modelled on the MIA (UK) or left to the common law. As a result of the *Triglav* case, it appeared that provincial legislation governing contracts of marine insurance would be, at least in part, inoperative. Industry groups urged the government to enact a federal marine insurance Act to resolve this uncertainty as to the scope and application of provincial marine insurance Acts and to use the MIA (UK) as the model.

The Canadian legislation does not differ in substance to any great degree from the MIA (UK). However, its drafting changes may offer some guidance in reforming the MIA. For example, it has been suggested that adopting the Canadian definition of "marine insurance" might help

address some uncertainties about the coverage of the MIA and the ICA in relation to insurance of mixed marine and non-marine transit risks.

1. William Tetley, *International Conflict of laws*, 1st ed, 1994, Blais, Montreal, Canada.
2. Contracts (Rights of Third Parties) Act 1999, ch.31 s. 10 (Eng)
3. Law Comm. Report No. 272 [2001]
4. Law Comm. R. No. 272; Scot. Law Comm. R. No. 184 [2001]
5. Rome Covention on the law applicable to Contractual Obligations 80/934, (O. J.) L 266, arts. 5-6 (1980)
6. See *Egon Oldendorff v. Libera Corporation*, [1995] 2Lloyd's Rep. 64.
7. In the *Iran Vojdan* the carrier didn't exercise its option as to the applicable law until after proceedings had already been issued.
8. See *Wilburn Boat v Fireman's Fund Insurance Co*, 348 US 310, 1955 AMC 467 (1955).
9. See La. Rev. Stat. Ann. [section] 22:655 (west 1995); Outer Continental Shelf Lands Act, 43 U.S.C. [section] 1332 (a)(2) (1994); Longshore and Harbor Workers' Compensation Act, 33 U.S.C. [section] 933 (1994)
10. See zavarilvana Skupnost Triglav v. Terrasses Jewellers Inc. and Bank of Montreal (1983) 1 RCS 283.

B: Civil Code Countries

I. Summary of marine insurance legislation in civil code countries

The marine insurance legislation in civil code countries is usually contained in general insurance contracts legislation or in commercial codes rather than in legislation applying specifically to marine insurance. Marine insurance legislation tends to be directory only and to preserve freedom to contract, subject to general contract principles relating to illegal and unfair contracts. For example, Germany has a general insurance law which deals with non-marine insurance, including land transport insurance. One of the main aims of that legislation was to protect the individual insured but marine insurance is subject only to the general laws of contract. Sweden, Denmark and France all have general insurance contracts legislation which contains provisions applicable both to insurance generally and to marine insurance in particular. However, most of the provisions relating to marine insurance are directory only. Therefore, the law of marine insurance in many civil code jurisdictions must be understood by reference to standard contractual terms as well as to any relevant legislation.

II. The differences between the laws of civil law countries and the ones of common law jurisdictions

The laws of civil code countries do not recognize the special status of warranties as contractual terms requiring strict compliance.

The laws of civil code countries have no equivalent to the duty of good faith in relation to insurance contracts, although some manifestations of the common law duties, notably the duty of disclosure, are commonly regulated.

The law relating to marine insurance contracts also differs significantly among civil code jurisdictions. These include differences in laws defining the scope of the duty of disclosure and sanctions for breach of duties of disclosure, the scope of the concept of alteration of risk and related sanctions.

III. The Harmonization of National Laws--The Comité Maritime International

At present, the Comité Maritime International (CMI) is the most relevant forum in which the international harmonisation of marine insurance law is being examined. The CMI is a non-governmental international organisation, the object of which is to contribute to the "unification of maritime law in all its aspects". Its members include the maritime law associations of over 50 countries.

CONCLUSION

It is true that the original insured, being a non-party to the reinsurance contract, can hardly claim his loss against the reinsurer, in consideration of the privity requirement of contract. Moreover, the practice of pay-to-be-paid, which is the primary rule of P & I insurance, has left no possibility to the insured or any injured third party of suing the reinsurer (P & I clubs) directly for recovery.

However, recent cases have indicated that, occasionally, the original insured or injured third party might act directly against the reinsurer as long as certain conditions are satisfied. Various theories are introduced in order to demonstrate the rationale of the trend. For instance, the argument that the indemnity nature of reinsurance contract has been transformed into liability in the insolvency of the insurer greatly challenges the privity theory of common law. Besides, the reinsurer's control over settlement, the insurer's role as an agent of the reinsurer and the insured's status of third-party beneficiary as well as the specific arrangement in reinsurance contract are also among the factors to be considered when determining the applicability of direct actions.

The insolvency of insurer, with no exceptions, is of particular importance and necessity when talking about the insured's rights against the reinsurer.

Above all, contractual arrangements probably are the best and safest way to protect the original insureds' rights against the reinsurers. It is equally important that the insured should pay enough attention to the choice of jurisdiction.

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